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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

July 14, 2004

VIA HAND DELIVERY AND E-MAIL

Tax Policy Team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ
United Kingdom

Re: Property Investment Fund Consultation Paper

Dear Sir or Madam:

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

NAREIT is the trade association for United States real estate investment trusts ("REITs") and publicly traded real estate companies. Members are U.S. REITs and other public 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 comments are organized as follows. First, in response to Chapter I of the Paper, NAREIT's comments provide a brief summary of the U.S. REIT industry, with a particular focus on how the U.S. REIT model has achieved in the U.S. many of the U.K. Government's objectives for a tax-transparent vehicle in the U.K. Second, the comments provide NAREIT's responses to relevant questions in the Paper. Questions from the Paper are marked in bold face throughout these comments.

♦ ♦ ♦

1875 Eye Street, NW, Suite 600, Washington, DC 20006-5413
Phone 202-739-9400 Fax 202-739-9401 www.nareit.com

NAREIT appreciates the opportunity to provide these comments to the U.K. Government with respect to proposed implementation of the PIF structure. Please contact the undersigned at (202) 739-9408 or tedwards@nareit.com if you would like further information or would like to discuss our comments in further detail.

Respectfully submitted,

Tony M. Edwards
Senior Vice President and General Counsel

Enclosures

Promoting More Flexible Investment in Property

Response to HMT & Inland Revenue Consultation Document

By the

National Association of Real Estate Investment Trusts®

July14, 2004

SUMMARY

NAREIT believes that adopting a tax-transparent structure that resembles the current United States REIT vehicle would capitalize on 44 years of experience with, and evolution of, REITs in the United States, and would tend to promote a number of the U.K. government's objectives. NAREIT believes that the success of REITs in the United States is largely attributable to the appropriate flexibility of the rules, which generally rely on market forces rather than government-issued regulations to determine various important matters such as debt levels, internal versus external management, whether to develop or purchase properties, which property types to emphasize, whether to retain and reinvest, or distribute, capital gains, and whether or not to be listed on a public stock exchange.

Chapter I: The Economic Context

"A.1 The Government invites views on the extent to which a PIF would (a) help to promote structural reform in the commercial property market and (b) encourage greater institutional investment and stimulate new development in the residential sector."

As set forth in more detail below, a description of the U.S. REIT model may offer a useful example of a vehicle that created stability in the real estate and financial sector and encouraged more diverse ownership of real estate generally.

Background of the U.S. REIT Industry

A. Early Years: 1960-1986

The U.S. Congress created the REIT structure in 1960 to make investments in large-scale, significant income-producing real estate accessible to investors from all walks of life. Congress decided that the only way for the average investor to access investments in larger-scale commercial properties was through pooling their capital into a single economic pursuit geared to the production of income through commercial real estate ownership. REITs offer distinct advantages for smaller investors: greater diversification through investing in a portfolio of properties rather than a single building and expert management by experienced real estate professionals.

REITs must comply with a number of requirements related to their operations and distributions, and must meet detailed information reporting requirements. The most fundamental of these requirements are as follows: 1) REITs must pay at least 90% of their taxable income to shareholders; 2) most of a REIT's assets must be real estate related (including investments in mortgage loans); 3) REITs must derive most of their income from real estate held for the long term; and, 4) REITs must be widely held.

In exchange for satisfying these requirements, REITs benefit from a dividends paid deduction so that most, if not all, of a REIT's income is taxed only at the shareholder level. On the other hand, REITs are limited in the earnings they may retain to meet their business needs. As a result, much of the capital for growth and property maintenance and betterment must come from new money raised in the investment marketplace from investors who have confidence in the REIT's future prospects and business plan, from recycling proceeds from like kind exchanges under section 1031 of the Internal Revenue Code of 1986,[1] or by attracting capital through joint ventures. Although U.S. law requires REITs to distribute at least 90% of their taxable income, taxable income is calculated after deducting depreciation and certain other non-cash expenses. Because depreciation is a non-cash expense, the distribution of the minimum requirement of 90% of taxable income allows REITs to retain additional capital, if deemed necessary and appropriate by REIT management.

REITs generally fall into three categories: equity REITs, which own real property; mortgage REITs, which own mortgages; and, hybrid REITs, which are a combination of the two. Within the equity REIT category are REITs that own apartment, health care, hotel, industrial, residential, retail, self-storage, office, and other types of property.[2]

1. Pre-1986 Limitation on Growth Due to Policy Constraints and Tax Shelter Competition

Despite the intentions of Congress to provide liquid real estate to all investors, the industry experienced very little growth for over 30 years, mainly for two reasons. First, from the beginning REITs were seriously constrained by policy limitations. REITs were mandated to be passive portfolios of real estate: REITs were permitted only to own real estate, not to directly operate or manage it. This meant that REITs needed to use third party independent contractors, whose economic interests might diverge from those of the REIT's owners, to operate and manage the properties. This was an arrangement the investment marketplace did not accept readily or warmly.

Second, during most of these years the overall non-REIT real estate investment landscape was colored by tax shelter-oriented characteristics available through direct and partnership ownership of real estate. Through the use of high nonrecourse debt levels and accelerated depreciation methods, interest and depreciation deductions significantly reduced taxable income -- in many

[1] In general, under section 1031 of the Internal Revenue Code of 1986, as amended, no gain or loss is recognized upon the exchange of investment property for “like kind” property as long as the exchange is completed within 180 days of the transfer of the exchanged property. Non-simultaneous exchanges also are permissible under section 1031 if certain criteria are met. Unless otherwise noted, all references herein to the “Code” are to the Internal Revenue Code of 1986, as amended, and all section references are to a section of the Code.
[2] See Exhibits 1 and 2 (pie chart of different types of REITs, and list of different types of properties owned by publicly traded equity REITs.)

cases leading to so-called “paper losses” used to shelter a taxpayer's other income. Since a REIT is geared specifically to create taxable income on a regular basis and a REIT, unlike a partnership, is not permitted to pass losses through to its owners, the REIT industry could not compete effectively for capital against tax shelters.

2. 1986 Tax Reform Act

In the Tax Reform Act of 1986 (the "1986 Act"), the U.S. Congress changed the real estate investment landscape. On the one hand, by limiting the deductibility of interest, lengthening depreciation periods and restricting the use of "passive losses," the 1986 Act drastically reduced the potential for real estate investment to generate tax shelter opportunities. This meant, going forward, that real estate investment needed to be on a more economic and income-oriented footing, such as that provided by REITs.

On the other hand, as part of the 1986 Act, Congress modified a significant policy constraint that had been imposed on REITs at the beginning. The Act permitted REITs not merely to own, but also to directly operate and manage most types of income producing commercial properties by providing "customary" services associated with real estate ownership. For most types of real estate (other than hotels, health care facilities and some other activities), the economic interests of the REIT's shareholders could be merged with those of the REIT's operators and managers.

B. Modern REIT Era: 1991-2004

Despite Congress' actions in 1986, significant REIT growth did not begin until 1991. One reason was the real estate economy experienced in the United States in the late 1980s and early 1990s. Until the late 1980s, financial institutions and insurance companies were significant providers of commercial real estate mortgage capital. Foreign investment, particularly from Japan, also helped buoy the marketplace. But by 1990 the combined impact of the Savings and Loan crisis, the 1986 Act, overbuilding during the 1980s by non-REITs and regulatory pressures on bank and insurance lenders, led to a nationwide depression in the real estate economy. During the early 1990s, commercial property values in the United States dropped between 30% and 50%. Credit and capital for commercial real estate became largely unavailable. As a result of this capital crunch, many borrowers defaulted on loans, resulting in losses by financial institutions and expense to the federal government.

Against this backdrop, starting in 1991, many private real estate companies realized that the most efficient, and sometimes sole, way to access capital was from the public marketplace utilizing REITs. At the same time, many investors decided that it was a good time to invest in commercial real estate, and the less restrictive operating rules made REITs a very attractive structure. These investors were right.

The following illustrates the tremendous growth of U.S. REITs over the past 30 years. At the end of 1974 there were only 54 REITs in the NAREIT Composite Index[3] with an equity market capitalization of $712 million. At the end of 2003 the number of REITs in the index had increased to 171 and the equity market capitalization had increased to $224 billion.[4]

Over the past 13 years, or what is known within the industry as the "modern REIT era," individual REITs have grown significantly in size. At the end of 1991, there were 136 REITs in the NAREIT Composite Index, and 135 of those companies had an equity market capitalization (*i.e.*, common shares outstanding multiplied by trading price) under $1 billion. Additionally, 100 of those 135 companies' equity market capitalization fell under $100 million. As of the first quarter of 2004, 78 out of the 175 companies in the NAREIT Composite Index had an equity market capitalization that exceeded $1 billion. Fifteen REITs had an equity market capitalization greater than $4 billion. As of June 30, 2004, the largest REIT has an equity market capitalization of almost $11 billion.[5]

A November/December 2002 article in the Federal Reserve Bank of Dallas' publication, *Southwest Economy* (the "Article"),[6] highlighted a number of important benefits of REITs.

Specifically, the Article discusses the decreased volatility and increased discipline listed equity REITs bring to the real estate market. Because REITs are typically (but not necessarily) publicly held, the author concluded that the significant amount and transparency of their financial information assists in discouraging excessive construction. Furthermore, because listed REITs typically raise most of their capital through the capital markets, the Article finds that they must act to maintain their stock price and are less likely to pursue irrational investment paths.

U.S. REITs have evolved substantially from their inception as passive holders of real estate. In response to market demands and changing government policy, over the last 20 years, the U.S. REIT generally has become a true operating company, departing significantly from its original passive restrictions while still focusing primarily on income producing-real estate.[7] As a result, the modern U.S. REIT is effectively a real estate operating company, not a passive holder of real estate.

To help achieve its goals and marketplace success, NAREIT recommends that the U.K. Government permit the PIF to actually operate real estate along the lines seen in the U.S. If so,

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[3] The NAREIT Composite Index includes all REITs currently trading on the New York Stock Exchange, the NASDAQ National Market System and the American Stock Exchange.
[4] See Exhibit 3
[5] See Exhibit 4.
[6] "Have REITs Helped Tame Texas Real Estate?" Southwest Economy (November/December 2002), pp. 13-18.
[7] See Exhibit 5-18 that demonstrate the growth and maturity of the U.S. REIT market.

the use of the "PIF" name may be misleading. To achieve the Government's goals, the tax-transparent entity should be seen as an operating entity, not merely a passive "investment fund". Consequently, we suggest that the U.K. Government consider applying a different name to the ultimate entity. For obvious reasons, we like "REIT."

Chapter 2: Possible Structures for a PIF

"A.2 To what extent would a listed PIF close the gap with net asset value ("NAV") and enable a wide retail investor base? How would an unlisted PIF meet these objectives? What additional investor restrictions might be necessary?"

I. Closing the Gap with Net Asset Value

Any discount to NAV may not necessarily be eliminated merely by creating the PIF vehicle. Nevertheless, the existence of a corporate level tax may be a contributing factor to this discount. The U.S. experience shows that the stock prices of REITs can be above NAV just as easily as they can be below NAV.[8] NAV is far from the only metric for valuing a REIT; others include "funds from operation" ("FFO"),[9]safety of and growth in dividends, and the valuation of management. In general, investors in the United States evaluate commercial real estate by reference to earnings and/or cash flow growth, and they use NAV only as one or more supplemental measures.

II. Enabling a Wide Retail Investor Base

A. Generally

The U.S. Congress created the REIT structure as a way to enable investors from all walks of life to invest in professionally managed, income-producing real estate in much the same way that this type of investment was available to high net worth individuals and larger institutions. To a large extent, this goal has been realized.

As of December 31, 2003, 22.5% of investment in U.S. REITs was owned by investors other than money managers of at least $100 million.[10] In addition, approximately 30% of the ownership in U.S. REITs was through mutual funds. Data from the mutual fund industry's trade association, the Investment Company Institute ("ICI"), indicates that approximately 77% of mutual fund assets is held by individuals.[11] This data suggests that a significant portion of the

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[8] See Exhibit 19 for a chart comparing NAV to share price from 1990-June 2004.
[9] NAREIT defines FFO as net income (computed in accordance with generally accepted accounting principles) excluding gains (or losses) from sales of property, plus depreciation and amortization, and after adjustments for unconsolidated partnerships and joint ventures. Adjustments for unconsolidated partnerships and joint ventures are calculated to reflect funds from operations on the same basis.
[10] See Exhibit 20. This data was derived from fillings of U.S. Securities and Exchange Commission ("SEC") Form 13F, a form which must be completed by money managers of at least $100 million.
[11] 2004 Mutual Fund Fact Book, published by the Investment Company Institute.

ownership of REITs held by mutual funds is indirectly held for the benefit of individuals. Thus, it appears that more than 40% of REIT ownership is held either directly or indirectly by individuals.

B. Listing Requirements

The Paper contemplates requiring PIFs to be listed companies. As you know, U.S. REITs do not need to be listed on an exchange, although many are.[12]

In the United States, many REITs have been formed as unlisted "incubator REITs," essentially to develop a track record prior to an eventual public listing. When initially formed, these companies may not own sufficient properties of sufficient size to warrant a public listing. However, as these companies increase their portfolios and their expertise, listing may become appropriate, and their prior existence as a REIT may be seen as a benefit to their new public shareholders.[13]

In addition, in light of the U.K. Government's objective to enable a wide investor base, permitting non-listed companies to qualify as PIFs would also permit those sophisticated investors who do not need the liquidity of a publicly listed entity to become investors in PIFs. The private U.S. 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.

C. Enabling a Wider Investor Base: Necessity of Additional Restrictions?

Beginning with the second half of the second taxable year of the entity, the REIT must have at least 100 shareholders and may not be "closely held". "Closely held" is defined as when five or fewer individuals own more than 50% of the value of the entity's stock, with a number of "look through" rules applying when determining ownership. For example, in most cases these rules require looking through a pension fund to its beneficiaries or a corporation to its shareholders in order to determine the ultimate individual shareholders of the REIT.

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[12] U.S. Internal Revenue Service ("IRS") data indicates the growth of private REITs over the past several years. This data demonstrates that for 1993, there were 354 U.S. REIT tax returns (Form 1120-REIT) filed, while in 2001, there were 1,031 REIT tax returns filed. Because the number of listed REITs actually decreased from 189 in 1993 to 182 in 2001, the IRS data underscores the growth in private REITs over this 8-year-period. See Exhibit 21 for further detail about the increase in the number of U.S. REITs from 1993 to 2001.

[13] See Exhibits 22 and 23, which provides information about listed U.S. REITs that started as unlisted REITs, as well as unlisted REITs that are in the process of becoming listed. In addition, UBS Investment Bank has published data demonstrating the tremendous increase in capital raised by public, nonlisted REITs (REITs with over 500 shareholders or $10 million in assets that are required to file financial information publicly, but whose shares are not publicly traded) over the last four years. For example, in 2000, public, nonlisted REITs raised $717 million, while in the 1st quarter alone of 2003, such companies raised approximately $1.5 billion.

In large part, these ownership restrictions have caused U.S. REITs to have a significant investor base and have by and large worked well. Most REITs create provisions in their formation documents to limit ownership in order to satisfy these rules.

"A.3 Should the property management arrangements of a PIF be prescribed through legislation?"

In the U.S., the majority of listed REITs are internally managed. Some information about U.S. REITs would be instructive here. In the U.S. REIT industry, the following terms are used to refer to the advising and management of REITs: "self-advised" or "externally-advised" and "self-managed" or "externally-managed". Although these terms are sometimes used interchangeably, as described below, there is a difference between them.

A self-**advised** REIT has its own employees who devote all of their time to the REIT just like the employees of any other publicly traded company. An externally-advised REIT typically hires a separate business entity, which can be an investment manager, bank or insurance company or an affiliate of these entities, to supervise the ongoing entity-level operations of the REIT in exchange for an advisory fee. Such advisory services include, for example, making decisions or recommendations to buy or sell a property, declare dividends, raise capital, or hire on-site mangers or other employees, in all cases subject to the oversight of the company's board of directors or trustees. An externally-advised REIT can have employees as well, but it subcontracts with an outside entity for supervisory services.

Some observers believe that there is a greater potential for conflicts of interest for an externally-advised REIT than for a self-advised REIT, especially when the REIT employees own the external advisor. In the last decade, many externally-advised REITs have addressed these potential conflicts of interest by various mechanisms, *e.g.*, requiring the REIT employees or sponsor to invest their own capital in the REIT and by linking the compensation of the outside advisor to performance-based criteria, rather than to assets owned by the REIT.

An externally-**managed** REIT typically is a REIT that uses outside entities (called "independent contractors") to provide on-site services to tenants at its properties. A self-managed REIT provides these services through its own employees. This definition applies to "equity REITs," which are REITs that own real estate (rather than "mortgage REITs", REITs that own mortgages).

As noted earlier, prior to 1986, REITs could not provide even "customary" services (like common area maintenance, common area lighting, etc.) at their properties, and therefore were required to hire independent contractors to manage their properties. These REITs were externally managed. Also, prior to 1986, REITs were not large enough "players" in the real estate industry to justify their being self-managed. In 1986, a legislative change allowed REITs to provide customary services at their properties. As a result, after 1986 most listed REITs became self-managed, and the REIT industry grew exponentially.

Following the legislative change in 1986, REITs began to provide the following services as part of their rental of real property: furnishing electricity (including sub-metering of electricity), water, heat, light, and air conditioning, elevator services, telephone answering services; performing general property maintenance and related services such as routine engineering and janitorial services, general cleaning services (including cleaning of windows, public entrances, exits and lobbies as well as the cleaning of a tenant's interior space); establishing rental terms, selecting tenants, entering into, negotiating and renewing leases, arranging for payment of taxes with respect to the property; maintaining exercise rooms, leasing space for vending machines (provided by independent third parties); providing parking facilities; and providing telecommunications services (by negotiating cable lease and easement agreements with internet service providers, broadcasters, long distance operators, and other service providers that provide telephone and other communications, cable, e-mail, video communications, electronic research, internet access, networking, safety and security systems, and environmental control systems and similar types of systems and services, or in some cases setting up cable service at a property).[14]

Recognizing the continued evolution of the real estate industry to a more service-oriented business, the U.S. Congress again amended the REIT provisions of the U.S. tax law in 1999 (effective January 1, 2001) to allow REITs to own up to 100% of the stock of taxpaying subsidiaries that can provide *noncustomary* services to REIT tenants and third parties.

Noncustomary services may include most anything, but the two most common are: 1) services that are rendered to a specific tenant, such as concierge services or assistance with groceries; and, 2) services ancillary to a real estate business, such as landscaping or shuttle buses to public transportation. These subsidiaries are known as "taxable REIT subsidiaries" or "TRSs". Because TRSs legally may provide virtually any service or product to anyone, constraints were placed on the TRS vehicle in order to ensure that the REIT remained a real estate-focused business. Specifically, no more than 20% of a REIT's gross assets may consist of its interests in TRSs, in the aggregate. Furthermore, if payments between a REIT and its affiliated TRS do not satisfy an "arm's length" standard, they are subject to a 100% "excise" tax.

Although there is no legal requirement that a REIT be self-advised, the capital markets tend to prefer that listed REITs be self-advised. Accordingly, about 90% of the publicly traded REITs that are NAREIT members are self-advised. This number represents 97% of the total number of REITs by market capitalization. Most non-traded REITs appear to be externally advised and managed.

NAREIT recommends that the U.K. Government similarly let the marketplace determine whether investors should invest in externally advised or managed REITs.

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[14] See Exhibit 24 for more detailed examples of permissible REIT services.

"A.4 Should the minimum gross income distribution requirement be 90 per cent (before depreciation)?"

The Paper suggests in paragraph 2.27 that PIFs be required to distribute at least 90% of income before depreciation. Based on the U.S. REIT experience, this distribution requirement appears to be too high and could be setting up a system for small investors that is likely to fail.

The experience of the U.S. system might be instructive here. As you know, U.S. REITs currently are required to distribute 90% of post-depreciation taxable income yearly. Taxable income in general is equal to gross income less expenses (including depreciation). Most REITs distribute in excess of 90% of taxable income (after depreciation).[15] The amount distributed typically is less than 90% pre-depreciation.[16] Any amount of taxable income retained by the REIT is taxed at the entity level.

In the case of U.S. REITs, the 90% of taxable income distribution requirement provides greater flexibility by allowing REITs to retain funds to make capital improvements to property when necessary and to pay down debt. In fact, some REITs would argue that a reduced distribution requirement would provide even greater flexibility for meeting their business needs. A higher distribution requirement could result in deteriorating property and higher debt levels. In fact, although the distribution requirement for REITs originally was 90% of taxable income, between 1981 and 2000, the distribution requirement was raised from 90% to 95% of taxable income. In 1999, Congress once again reduced the distribution requirement to 90% of taxable income. At the same time, many investors view REIT stocks as reasonably dependable and potentially growing sources of dividend income; as a result, REITs work hard to meet these market desires by seeking to increase their dividend over time.

We also note that, in the U.S. real estate industry, most property is not triple net lease; as a result, there is considerable tenant demand for landlord-provided services as well as capital improvements. While we believe the U.K. market today may not reflect this range of tenant demand upon landlords, as the U.K. market evolves this demand may well increase. Thus, NAREIT recommends that the U.K. Government permit PIFs to have the flexibility to retain capital in order to provide such services and to engage in a wide variety of real estate services to meet tenant needs.

Another important aspect of the U.S. real estate market is that many U.S. REITs have used capital to renovate older properties, thereby benefiting tenants and the public. A similar benefit

[15] See Exhibit 25, which shows the portion of REIT distributions for the 1995-2003 period that are considered "return of capital." This portion is the amount of the distribution that was in excess of earnings and profits.
[16] NAREIT collects data on the dividend payout ratio of the top 100 equity REITs as a percentage of funds from operations ("FFO"), which, in very simple terms, is somewhat akin to book operating income less true cash expenses. FFO does not include depreciation or sales proceeds. Between 1994 and the end of 2003, these REITs distributed dividends in a range from approximately 60% to 90% of FFO. See Exhibit 26.

may be available to the U.K. public and investors if the distribution requirement is set at a level that allows PIFs to use retained capital for renovation purposes.

"A.5 What level of borrowing should be permitted in order to best deliver increased market scrutiny and stability in the property investment market?"

As you know, U.S. law does not provide a limit on the amount of debt that a REIT may incur. NAREIT believes that market forces are the best determinants of the appropriate level of gearing. Therefore, NAREIT recommends that legislation provide the flexibility to meet different market challenges and not limit the level of gearing for a PIF.

However, to the private markets, the public market (*e.g.*, analysts and investors) in the U.S. has encouraged listed REITs to incur a lower level of debt. These market forces, rather than specific legislative requirements, have created this situation. As a result, in the fourth quarter of 2003, the average debt to market capitalization for equity REITs (property-owning REITs, as opposed to REITs that own mortgages or a combination of mortgages and property) was 41.8%.[17] Additionally, the market may consider different debt amounts appropriate for different property sectors.[18] Rating agencies also provide an outside force to limit gearing. For example, as of March 31, 2004, 52 U.S. REITs, or 65% of the industry by market capitalization, had investment grade ratings on their outstanding debt issues. For these companies to increase borrowing, they must be prepared to deal with credit agency concerns and expectations. Furthermore, as the capital markets have become more comfortable with publicly traded REITs and their use of debt, the level of leverage borne by REITs has fluctuated, sometimes increasing as market conditions warranted.

The lower debt levels associated with REITs compared to real estate investment in the U.S. overall have had a positive effect throughout the economy. Average debt levels for U.S. REITs are 40-50% of market capitalization, compared to leverage of 75% and often higher that is used when real estate is privately owned. The higher equity capital cushions REITs from the negative effects of fluctuations in the real estate market that have traditionally occurred. The ability of REITs better to withstand market downturns should have a stabilizing effect on the real estate industry and its lenders, resulting in fewer future bankruptcies and work-outs. Consequently, the general U.S. economy has benefited from reduced real estate losses by federally insured financial institutions.

"A6. In order to meet the Government's stated objectives, and as a condition for different corporation tax treatment, should there be restrictions on the development and investment activity of a PIF, and the definition of allowable property? How should this be achieved? Any recommendations should provide a clear link to the rationale for its inclusion."

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[17] See Exhibit 27, which presents historical leverage of listed equity (property-owning) REITs.
[18] See Exhibit 28, Summary of Financial Leverage By Property Sector (Fourth Quarter 2003).

I. Development

The U.S. experience may be instructive in this context. U.S. REITs may develop property for their own account that, once developed, they hold for investment. In the U.S. context, the relevant inquiry is whether the property is held as investment (for the long term) or as inventory as a dealer (for the short term). This rule is desirable because it provides the flexibility for those REITs that have property development expertise to benefit their shareholders by undertaking development for their own account, thereby achieving cost efficiency and savings. This rule also helps spur development by REITs with particular development expertise in blighted areas and redevelopment in all areas. Other REITs choose not to develop for their own account.

Gains attributable to the sale of "dealer property" are taxed to the REIT at a 100% rate. Thus, the REIT faces strong discouragement, but not loss of REIT status, from directly developing property for third parties. The determination of whether property is "dealer property" is based on the facts and circumstances of the situation, but a safe harbor is available. Specifically, the 100% tax is not imposed on a REIT's property sales if the REIT has: 1) held the property for at least 4 years; 2) not spent, in the form of capital expenditures, more than 30% of the net selling price of the property over the last 4 years; 3) either not made more than 7 sales of property within the taxable year or the aggregate adjusted bases of property sold during the taxable year does not exceed 10% of the aggregate adjusted bases of all of the REIT's assets as of the beginning of the taxable year; and, 4) certain other requirements are met.

Many REITs have established a core expertise in developing properties, and therefore develop properties not only for their own account, but also for third parties through a taxable REIT subsidiary or "TRS". Profits of the TRS are taxable at the entity level, but the after-tax income of the TRS could be distributed to the REIT in the form of dividends, which are qualifying income (as described below). Thus, REIT shareholders benefit from the TRS activities and a normal corporate tax is imposed on activities not suitable under the REIT umbrella.

Additionally, in recent years, many REITs have expanded their investment portfolios through the use of joint ventures. A property owner may contribute property to a joint venture entity while the REIT contributes capital and/or manages and develops the property. By acquiring interests in properties through joint ventures, REITs greatly expand their property investment opportunities without having to secure additional capital from the public markets.

II. Allowable Income and Assets

Again, the U.S. experience may be instructive here. In the U.S. context, in order for U.S. REITs to remain real estate-focused, REITs must satisfy annual income tests and quarterly asset tests. Annually, at least 75% of a REIT's income must be from real estate sources such as "rents from real property" and interest on loans secured by mortgages on real property, gain from the sale of real property and mortgages held for investment, dividends from other REITs and gain attributable to the sale of shares of other REITs, abatements and refunds of taxes on real property, and other related income.[19] Furthermore, at least 95% of a REIT's income must be derived from those sources included in the 75% test, as well as certain other sources of generally passive income, such as dividends (including dividends from TRSs) and non-real estate interest.[20] In connection with the types of permissible assets, U.S. tax law requires that at the end of each calendar quarter, at least 75% of the value of a REIT's total assets be represented by "real estate assets," cash and cash items (including receivables) and Government securities.[21] These requirements are discussed in more detail below.

A. Income

For most equity (*i.e.,* property owning) REITs, the majority of their income is derived from "rents from real property" as this term is specifically defined under U.S. tax law. In general, this term is defined as all rents from interests in real property, charges for services customarily rendered in connection with the rental of real property, and rent attributable to personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to the personal property is not greater than 15% of the total rent for the taxable year attributable to the total rent for the taxable year for both real and personal property.

As noted in the response to Question A.3, above, since 1986, REITs have provided a wide variety of services that are considered customary.[22] To the extent that a REIT derives less than 1% of the income from a specific property as a result of providing "noncustomary" services, the rental income from the property that is not attributable to such services may continue to qualify as "rents from real property". If the income attributable to noncustomary services were in excess of this 1% threshold, the REIT should use a TRS or independent third party to provide the service; otherwise the entire amount of rental income from the property would consist of nonqualifying income. To the extent that more than 5% of a REIT's income were comprised of nonqualifying income, the REIT could face a loss of REIT status, and with it, the ability to deduct dividend payments.

Furthermore, a U.S. lodging and healthcare REIT may own such facilities if it leases the facilities to a tenant who either operates the properties itself or hires an operator to operate the properties.

Allowing REITs to own and loan money to owners of health care facilities helps to increase the number and quality of these facilities, which can be especially useful as the aging "baby boomer" generation begins to need such facilities.

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[19] §856(c)(3)
[20] §856(c)(2).
[21] §856(c)(4). Additionally, a REIT cannot own, directly or indirectly, more than 10% of the voting securities of any corporation other than another REIT, TRS or qualified REIT subsidiary ("QRS"), a wholly-owned subsidiary of the REIT whose assets and income are considered owned by the REIT for tax purposes. Nor can a REIT own stock in a corporation (other than a REIT, TRS or QRS) the value of whose stock compromise more than 20% of the value of the REIT's gross assets. A REIT can own up to 100% of the stock of a TRS, however.
[22] See Exhibit 23 for a partial list of such services.

Hotel REITs, but not health care REITs, may own up to 100% of TRSs to which they lease their properties if the TRSs hire independent operators to operate the hotels. Other REITs, including health care REITs, may not own (indirectly or by applying certain constructive ownership rules) more than 10% of any tenant who rents one of their facilities; ownership of any more than this amount would disqualify all rent from such facility from constituting qualifying rental income.

B. Assets

For U.S. REITs, the term "real estate assets" is defined broadly to include interests in real property (fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon), as well as interests in mortgages on real property, shares of other REITs, and any property that is attributable to the temporary investment of new capital.[23] This broad definition allows for a great amount of flexibility, not just for a newly formed REIT as it looks for investment opportunities, but also for the existing REIT as it considers other types of real estate related investment opportunities. In addition, a U.S. REIT may own real property in the U.S. or internationally.[24]

Flexibility has been important to U.S. REITs because it has allowed them to own new types of properties as market conditions change. For example, in 1994, office REITs comprised only four percent of the total U.S. REIT market while in 2004, office REITs comprised 18 percent of the total U.S. REIT market. Similarly, retail REITs were 35 percent of the total REIT market in 1994, and today they are 28 percent of this market.[25]

The broad definition of "real estate assets" also has allowed REITs to invest in all types of loans secured by real property. For example, in recent years, REITs have enhanced their debt portfolios by providing short-term mezzanine financing to borrowers secured by the borrower's ownership interest in the tax-transparent entity that owns the relevant property. Mezzanine financing provides for a higher than average rate of return as well as fairly expedited default procedures in the event of default. A loan secured by a partnership or limited liability company interest is treated as a "real estate asset" if a substantial portion of the assets of the pledged entity consist of real property having a value equal to or in excess of the amount of the loan, and a number of related conditions are satisfied.

NAREIT recommends that any U.K. tax-transparent entity likewise be required to satisfy broadly defined real estate tests. As a final point, NAREIT suggests that such entity be permitted to invest in, and earn qualifying income from, a U.S. REIT.

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[23] For example, if the REIT raises cash in an equity offering and invests the cash in certificates of deposits or other liquid securities, these assets would satisfy the 75% asset test for a one-year period. Income from such temporary investments would also qualify during the one-year period for purposes of the income tests described previously.
[24] Rev. Rul. 74-191, 1974-1 C.B. 170.
[25] See Exhibit 4.

"A.7 How could the structure of a PIF be designed to ensure a better quality of stock?"

In order to ensure a better quality of stock, the PIF should be a long-term investor in real estate as opposed to a short-term "trader" or "dealer" in real estate, and the PIF should be provided with the flexibility to develop and manage property for its own account. As noted above, incentives should be provided to encourage the PIF to hold property for the long term. At the same time, the PIF should be provided with the flexibility to sell property if the appropriate opportunity presents itself; thus, we would advise against imposing a minimum holding period for property. Situations sometimes arise when a REIT plans to hold property for the long term, but an unsolicited and highly favorable bid is received on the property. By requiring the REIT to decline this bid, the REIT's shareholders could be disadvantaged by losing the benefit of the sale.

We believe that the system applicable to U.S. REITs, whereby REITs are taxed at 100% on gain attributable to property held primarily for sale, unless they hold the property for investment purposes under a "facts and circumstances" test or meet a safe harbor, succeeds in making REITs long-term investors in real estate. By encouraging the PIF to develop and hold property for investment, the PIF is likely to undertake to improve the property, thereby improving the quality of stock.

"A.8 How could a PIF deliver high quality residential property for the entire range of rented accommodation, and what features of a PIF would help to achieve this aim, while meeting the objective to ensure no overall cost of the Exchequer?"

The U.S. experience in the REIT industry has been that listed companies have tended to specialize in a specific property sector in which they develop particular expertise. Different property sectors face different issues. For example, there is greater tenant turnover in the multifamily (residential) sector because the leases are much shorter. Also, apartment properties tend to be smaller than properties in other sectors. Furthermore, apartment dwellers expect different types of services than do office or warehouse tenants, such as internet access, cable television service, exercise facilities, etc. Allowing companies to specialize in the ownership of apartment properties can lead to those companies being known as national landlords. Tenants from one part of the country familiar with that landlord's practices may be more likely to rent subsequent properties from that landlord. To require that each PIF own some residential property might require managers to venture outside their area of expertise.

The U.K. Government's goals in the residential sector are to raise standards, provide an alternative to the highly geared, buy-to-let market, and to stimulate greater development by providing a vehicle into which new properties can be converted and managed more efficiently.

By allowing a specialized, residential PIF sector to develop, these goals are more likely to be achieved than by requiring each PIF to own some residential properties. However, some companies add value by developing or operating mixed use facilities, including residential.

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NAREIT recommends that any new tax-transparent structure in the U.K. provide companies with the maximum flexibility to design a company that works best for its shareholders, its tenants, and the public.

"A.9 How could a PIF be structured to encourage greater flexibility for occupiers in the commercial sector? What conditions could be set for PIF landlords to ensure high standards in both residential and commercial sectors?"

To increase flexibility for occupiers, it also is necessary to increase flexibility for the PIF. An important step in this direction would be to allow the PIF to retain sufficient capital to make capital expenditures and repairs, if necessary. These expenditures can include modifying properties to tenant specifications, increasing access to technology-related service, such as high-speed internet access, and video conferencing services. As noted above, the distribution requirement should not be set so high as to discourage PIFs from undertaking these expenditures.

"A.10 To ensure no overall cost for the Exchequer, what is the most appropriate system for taxation at the PIF level? Is it appropriate to require a PIF to distribute a high proportion of realized capital gains?"

NAREIT believes that the tax treatment of REITs in the U.S. has been one of several components leading to the success of REITs in the U.S. Consequently, NAREIT would recommend a similar tax-transparent system for the U.K. In the U.S. system, REITs are required to distribute 90% of their taxable income (other than net capital gains). If they do so, and meet various other qualification requirements, they are entitled to deduct their distributions from taxable income. Furthermore, by requiring REITs to satisfy two source-of-income tests, the REIT has flexibility to earn a small amount of non-real estate and non-passive income without taxation and/or risk of loss of REIT status.

Historically, the threat of the loss of REIT status has provided a strong incentive for the REIT to monitor its income carefully to ensure that it does not earn an inappropriate amount of nonqualifying income. Nevertheless, problems have arisen when unintended oversights or misinterpretations of applicable rules could have caused disqualification of the REIT. The approach contained in section 285(f)(1) of legislation passed by the U.S. House of Representatives on June 17, 2004, H.R. 4520, which, in general, would allow a REIT either to correct a "de minimis" violation or to pay a monetary fine in lieu of disqualification for a "de minimis" violation of the REIT rules, is a preferable regime that balances the incentive to comply with the REIT rules with the realities of running a REIT. To the extent that U.S. REITs have remaining taxable income after the deduction for dividends paid, they pay a corporate level tax on this income. REITs can distribute capital gains and receive a deduction for such distributions, but they are not required to do so. Again, to the extent they retain capital gains, they are subject to tax.

If the U.S. REIT elects to pay a corporate level tax on retained capital gains, its shareholders: 1) include in income their proportionate share of the undistributed capital gains; 2) receive a tax credit for their proportionate share of the tax paid by the REIT; and 3) increase their adjusted tax basis in the REIT's stock by the difference between the amount of their capital gain and their share of the tax paid by the REIT. Essentially, a REIT's capital gain income is subject to only one level of tax, regardless of whether distributed.

In NAREIT's view, the most appropriate system of taxation would include the following factors: 1) a corporate level tax, 2) a dividends paid deduction; and, 3) rules that would allow for the tax free treatment of realized capital gains if the gains are reinvested within a specific time period.

The third point is similar to the "like kind exchange" rules of section 1031 that are part of the U.S. tax system.[26] Under section 1031, if a taxpayer exchanges property held for investment with like kind property held for investment, tax on the gain from the exchanged property may be deferred. This rule can be useful for those companies that are seeking to change or upgrade their class of properties, but would be prevented from doing so by the cost of the tax on capital gains, or for those companies that desire to change their investment focus from a specific geographic area to another area. Because the companies have not changed their core focus and have not received cash in the exchange, it seems inappropriate to impose a tax or a distribution requirement on the gain inherent in their exchanged properties.

A very useful alternative approach to like kind exchanges has been suggested by the Joint Committee on Taxation (the "JCT", a Congressional committee responsible for tax-related legislation) as part of a simplification study concerning the U.S. system of taxation.[27] The JCT recommended that a taxpayer should be permitted to elect to rollover gain from the disposition of appreciated business or investment property if "like-kind" property is acquired by the taxpayer within 180 days before or after the date of the disposition. The U.K. could consider implementing a similar approach.

"A.12 In the context of the modernized stamp duty system, and the wider tax implications for different types of property investment the Government invites views on what the appropriate liability for Stamp Duty Reserve Tax (SDRT) and Stamp Duty Land Tax (SDLT) should be for a PIF and investors in a PIF. This should reflect the object to ensure no overall cost of the Exchequer."

As you may know, the U.S. does not have a stamp duty system *per se*. Certain states do impose a transfer and/or recordation tax on the transfer of real estate and/or the recordation of a deed. If certain conditions are met, some states provide exemptions that allow property owners to transfer real estate assets to a REIT without incurring any tax. Thus, NAREIT's only comment is that any stamp duty imposed on a PIF and/or its investors should be reasonable so as not to discourage companies from converting to PIF status.

[26] See footnote 1 and its accompanying text.
[27] See http://www.house.gov/jct/x-27-01.pdf

"A.14 The Government is interested, in the context of ensuring no overall cost to the Exchequer, in the factors it should take into account in setting the scale, nature and timing of the conversion charge to a PIF."

NAREIT recommends that any exit charge imposed on those companies that convert to PIF status should be modest and reasonable.

A few factors in the U.S. tax laws operate to encourage the formation of REITs by deferring (and possibly eliminating) any "toll charge" that could apply to the conversion of an ordinary corporation (a "C corporation") to a REIT. Ordinarily, a C corporation that converts to a REIT is required to pay an entity-level tax on the appreciation inherent in its assets (a "built-in gains tax"). A special provision (§ 1374) allows such a C corporation to choose to defer that tax on conversion and instead pay tax on any built in appreciation to the extent that its former "C corporation assets" are sold and the gain is recognized in the 10 years following its REIT conversion. Following the close of this 10-year period, the REIT can sell the assets without paying a REIT-level tax. Any gain, whether recognized before or after the expiration of the 10-year period following conversion to a REIT is subject to the usual requirement that it either be distributed by, or taxed to, the REIT. When the gain recognition occurs within the 10-year period, however, it is measured net of any entity-level tax imposed on the built-in gain inherited from the predecessor C corporation.

A corollary to the ability to make a "§ 1374 election" is the "like kind exchange" provisions of § 1031.[28] Under this provision, an entity may exchange one parcel of investment property for another parcel of investment property through a tax-deferred "like kind exchange". By exchanging some of its former C corporation assets for replacement properties, the REIT can carry over its holding period to the replacement properties, in which case the built-in gains tax is only triggered to the extent that the replacement properties are subsequently sold at a gain within the original 10-year period following the conversion to REIT status.

Finally, another method for deferring tax in the U.S. is through the "UPREIT" (or "umbrella partnership REIT") structure. In general, U.S. tax law provides that the transfer of appreciated property to a REIT in exchange for stock in the REIT is a taxable transfer. On the other hand, in general, the transfer of appreciated property to a partnership, including a partnership owned mostly by a REIT, is not a taxable transfer. As a result, investors may transfer on a tax-deferred basis their appreciated properties to a partnership in which the REIT is the general partner and in which the REIT owns majority of the partnership interests (an "operating partnership" or "OP") in exchange for partnership units. The OP owns most or all of the REIT's properties. After approximately one year, investors may exchange their OP units for REIT stock or cash (at the REIT's option) in a taxable transfer.

Many large private property owners typically own properties through partnerships or other fiscally transparent entities. In general, these owners can convert their property interests into

[28] See footnote 1 and its accompanying text.

REIT interests (often on a publicly traded basis) on a tax-deferred basis by transferring their partnership interests to a REIT's OP in a tax-free transfer but paying tax upon the later sale or exchange of the OP units into REIT stock or cash. Doing so allows these private property owners to benefit from diversifying into a publicly traded REIT's portfolio and to enjoy the increased liquidity that ownership of a publicly traded entity provides. Most new equity REITs are set up in the UPREIT structure to facilitate future tax-free transfers by investors to the OP. Approximately 2/3 of publicly traded REITs are organized in an UPREIT structure.

Finally, it should be noted that the U.S. does have a form of an exit tax that cannot be avoided. An ordinary corporation that converts to REIT status must distribute its non-REIT current and accumulated "earnings and profits" to shareholders by the end of its first year as a REIT. "Earnings and profits" is a concept of U.S. tax law that is roughly equivalent to the financial accounting concept of retained earnings. Essentially, this distribution forces the converting corporation to distribute a taxable dividend to its shareholders to the extent of previously retained C corporation earnings and profits, thus ensuring that income earned by the corporation (and presumably previously taxed at the corporate level) is taxed at the shareholder level. The REIT is not entitled to a dividends paid deduction for this distribution.

"A.15 With no other changes in taxation, what impact might the introduction of a PIF have on alternative options for property investment? What, if any, are the implications for the distribution rules for authorized investment funds?"

Again, the U.S. experience might be instructive on this issue. Although, in general, the introduction of, and liberalization of the rules relating to, the REIT vehicle has led to greater REIT ownership of institutional grade real estate, the percentage ownership of such property by REITs is still relatively small, indicating that other methods of property investment are used when the REIT vehicle is not appropriate.

An August 2003 study by Prudential Real Estate Investors[29] provides a breakdown of REIT ownership by property sector. For example, as of 2002, REITs owned only 7.6% of the total real estate of the office sector. The sector in which REITs owned the greatest percentage of property was the mall retail sector, in which REITs owned 36.3% of the total properties.

Because REITs must satisfy a myriad of rules relating to income, assets, distributions and compliance, some investors may believe that the REIT vehicle is not an appropriate vehicle for their investment in real estate. Furthermore, REITs cannot pass through losses to shareholders in the same way as partnerships. This data would tend to indicate that the PIF vehicle would not necessarily have a negative effect on other forms of property ownership in the U.K.

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[29] Robert Hess and Youguo Liang, "*Finding Niches-Trends in Public-Market Commerical Real Estate Penetration From 1997-2002*," Prudential Real Estate Investors (August 2003).

"A.19 The Government would welcome views on whether these proposed changes would significantly increase regulatory burden and compliance costs, and if so how?"

In the U.S. context, compliance costs are reduced by using a REIT to hold property rather than entities treated as partnerships for tax purposes, which hold more commercial real estate than any other vehicle. By virtue of the deduction allowed to REITs for dividends paid and certain rules providing for the pass-through of character in limited circumstances, to a large extent, REITs are taxed as pass-through entities. If they distribute all of their taxable income, this income is taxed only at the shareholder level. REITs indicate to shareholders in "Form 1099-DIV" the amount of dividends distributed and the type of dividend received (*e.g.*, what portion of the dividend is ordinary income or capital gain, and of the capital gain, what portion is taxed at the long term or short term capital gain rate).

Conversely, partnerships or limited liability companies are typically taxed as true pass-through entities, posing significant complexity with regard to partnership allocations and distributions (which are reported by the partnership to partners on a detailed, and rather complicated, "Schedule K-1"). Investors typically prefer receiving a 1099 to a K-1 because it is much simpler to process and it is received months earlier than a K-1. Once the rules are known, the regulatory costs tend to be modest in light of the positive effect of the overall structure. If rules similar to the K-1 reporting apply to partnership reporting in the U.K., a PIF could simplify the reporting process.