January 26, 2006

Michael Swan
HM Revenue and Customs
CT&VAT Products and Processes
100 Parliament Street
London SW1A 2BQ
United Kingdom

Re: Comments on UK REIT Draft Legislation

Dear Mr. Swan:

The National Association of Real Estate Investment Trusts® ("NAREIT") greatly appreciates the opportunity to provide its comments on the draft legislation contained in the 2005 Pre-Budget Report concerning the potential authorization of a U.K. real estate investment trust ("REIT"). We strongly believe that a U.K. REIT would provide the U.K. with a time-tested medium for investing in real property and would meet the U.K. Government's objectives of encouraging an efficient and flexible property investment market, with fairness for all taxpayers.

NAREIT is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in the U.S. property and investment marketplace. 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.

As mentioned in our earlier submissions to the U.K. Government, NAREIT believes that adoption of a tax-transparent approach that resembles the current United States REIT model would capitalize on more than 45 years of experience with, and the evolution of, REITs in the United States, and should promote a number of the U.K. government's objectives.

Our specific comments follow:

Clause 4(7): One Class of Stock

NAREIT believes that there are supportable business and technical reasons why a U.K. REIT would issue more than one class of stock, and contends that there should be no restriction from doing so.

On the business front, U.S. REITs find that, like other listed companies, preferred stock is a very useful capital-raising alternative that provides capital for a long term at a reasonable price. There are many investors, both U.S. and non-U.S., who find preferred stock appealing because of the anticipated yield and its preference over common shareholder payments. These investors value the somewhat higher yields, and are willing to forgo some of the potential for price gains in return for the greater yield. Issuers (both REITs and non-REITs) use preferred stock because, unlike debt, the issuer does not have to repay the principal unless it chooses to redeem the preferred stock. Further, at times during capital markets cycles, the payment coupon on preferred can be quite low.

As an example, two thirds of listed U.S. REITs (measured by market capitalization) currently have investment grade ratings, and quite a number of these companies issue preferred stock to prudently manage their balance sheets. Preferred stock is not treated as debt by the credit rating agencies, so the use of preferred stock, instead of debt, can improve companies' credit ratings and significantly lower their total cost of capital. We believe it would be a serious mistake in direction for the U.K. REIT legislation to handicap U.K. REITs from taking advantage of a fundamental capital-raising tool used by companies around the world.

The American experience also shows that there are substantial technical difficulties in interpreting what constitutes a single class of stock. The U.S. tax code has long allowed a limited number of individuals to create a pass-through entity (akin to a partnership) called an S corporation. One of the requirements of an S corporation is that it must have a single class of stock.[1] Over the years, a multitude of problems have arisen as to whether a particular instrument was a separate class of stock, *e.g.*, long-term debt. These questions caused so much uncertainty that later legislation crafted a safe harbor under which certain debt instruments are presumptively considered debt rather than stock.[2] However, we understand that there continue to be significant interpretive and implementation problems even with this safe harbor in effect.

Based on the business reasons and complex administrative issues arising from a single class of stock test, NAREIT strongly recommends that the final legislation omit this restriction.

<u>Clause 4(8): 10% Ownership Limit</u>

In NAREIT's previous comments, dated May 27, 2005, we supported the idea that U.K. REIT legislation should contain shareholder ownership restrictions, both to assure that the U.K. REIT is widely held and to prevent it from being controlled by one entity. As we detailed in our previous letter, in the United States five or fewer individuals can not own more than 50% of the vote or value of a U.S. REIT's securities.[3]

To satisfy the "5/50" test, many U.S. REITs have provisions in their organizational charters prohibiting any shareholder from owning more than a set percentage of the company's stock (often 9.9%) unless the Board, beforehand, allows the stock acquisition after ascertaining whether the ownership threshold would violate the 5/50 test. In addition, the IRS has approved "excess share" provisions in a REIT's by-laws under which any acquisition of shares that creates a violation of the 5/50 rule effectuates a transfer of the shares creating the 5/50 violation to a trust that benefits another organization, usually a charity.[4]

[1] I.R.C. § 1361(b)(1)(D).
[2] I.R.C. § 1361(c)(5).
[3] I.R.C. § 856(h).
[4] *See*, *e.g.*, PLR 9719018.

However, we believe that the 10% limit proposed in the pre-Budget report is overly restrictive. For example, it is quite possible that a REIT might have such a good track record that an institutional investor might want more than a 10% stake in the enterprise. Yet, the draft legislation would preclude this investment. Moreover, one REIT might want to acquire another REIT over a period of time in a "creeping acquisition", and a 10% limit would amount to a legislative anti-takeover defense that is counter to increasingly accepted global corporate governance best practices. If the purpose of the 10% ownership limit is to prevent one corporation from controlling a U.K. REIT, we suggest that the limit be raised to somewhere between the proposed 10% limit and the 50% rule long used in the United States.

At the very least, we recommend that the final legislation create an exception to the 10% ownership test for pass-through vehicles, such as mutual funds and partnerships, with the 10% limit tested at the beneficial owner level. We also suggest that the 10% limit not apply to another U.K. REIT, since a U.K. REIT will, by definition, meet all of the tests imposed to satisfy the special regime (so it should not be looked upon as a "prohibited" owner). As we stated in our previous submissions, in the United States REIT stock is considered a "real estate asset"[5] that is a qualified asset that generates qualified income under the REIT tests.

Further, we suggest that any ownership limit not apply to management's stake in a U.K. REIT. One of the reasons that U.S. REITs have become so accepted in the marketplace is that management in the REIT initial public offerings (IPO), starting in the early 1990s, retained a substantial stake in the business enterprise. Investors appreciate that managers with a substantial investment in the business have their interests fully aligned with other shareholders. Although the managers often owned much more than 10% of a REIT after an IPO, these stakes over time have diminished to below 10% because the REIT has acquired new shareholders through REIT acquisitions and mergers as well as through secondary equity offerings. Imposing a 10% limit on executives working for the REIT would have the unfortunate effect of encouraging the formation of companies in which managers do not have a substantial equity stake.

Similarly, we recommend that the 10% limit not apply to ownership levels in effect for a company before a designated date, *e.g.*, the date the Pre-Budget Report was issued. Shareholders in the United States generally prefer investing in an existing company that has a proven management track record as compared to a "blind pool" in which managers are provided complete flexibility in forming a new enterprise. Since many existing U.K. listed property companies have institutional investors owning more than 10% of the company's stock, the U.K. REIT law would in effect encourage the formation of blind pools over established companies, unless the law contained an exception for existing companies.

<u>Clause 5(7): 95% Distribution Test</u>

In the United States, a REIT was required to distribute 90% of its taxable income (patterned after the U.S. mutual fund tax rules) from the original 1960 legislation until 1980, when the requirement was raised to 95%. We note that in computing "taxable income", a U.S. REIT

[5] I.R.C. § 856(c)(5)(B).

deducts from gross income depreciation of the entire building; whereas we understand that in the U.K. a taxpayer only depreciates plant and machinery. This higher level of depreciation provides a U.S. REIT with a valuable source of capital to maintain and upgrade its assets.

After 1980, REITs became more active in operating commercial real estate and increased their need for capital to renovate and improve their buildings (thereby bettering services to their tenants). In 1999, Congress recognized the need to allow a REIT to retain more of its capital to maintain and improve its assets and therefore lowered the distribution requirement back to the historic 90% level.

As an example, the 90% threshold proved to be an important tool after the 9-11 Al Qaeda attacks. In particular, lodging REIT revenues plummeted because of increased vacancies and they needed significant capital to avoid loan defaults. The extra 5% of their taxable income provided a needed margin of safety to allow them to satisfy all of their financial obligations until occupancies returned to normal levels.

NAREIT recommends that the U.K. track the approach taken now in the United States by imposing a 90% distribution requirement. This change is especially important given the lower depreciation charges that will be available to U.K. REITs compared to U.S. REITs.

Clause 12: Financing Cost

As noted in our prior submissions, the last ten years of experience in the U.S. demonstrates that public capital market forces tend to reduce the overall level of borrowing by U.S. publicly traded REITs compared to commercial real estate held privately. With that said, the U.S. REIT legislation does not impose significant restrictions on the levels of debt incurred by any taxpayer (whether a REIT or other type of taxpayer) with respect to debt from unrelated parties, and we do not believe the U.K. should do so in connection with U.K. REITs.

At a minimum, any limitation on borrowing should take into account the special characteristics of a REIT, which is required to distribute substantially all of its “taxable” income and therefore needs flexible sources of capital to meet business demands. For instance, flexibility in borrowing should be provided to a REIT because a REIT might need to borrow additional funds during a recession when it may be otherwise difficult to obtain equity capital. These funds could be needed to pay for tenant improvements

With respect to one possible aim of a gearing limitation on U.K. REITs, when the U.K. calculates the foregone tax revenues due to borrowings by the REIT, it should consider that interest earned by U.K. lenders will be subject to U.K. tax. If the U.K. Government’s 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 U.K, then it should consider adopting a rule against this specific abuse not just for real estate investors, but for all taxpayers.

For example, the U.S. 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 if the interest earned by the lender is not subject to U.S. 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 U.K.’s potential concern about the use of interest to reduce a U.K. REIT’s income (and thus, the amount of taxable income distributed to shareholders) without a corresponding increase in the lender’s income subject to U.K. tax.

That being said, it seems to us that if U.K. REIT legislation is to contain an inflexible coverage ratio test, the limit proposed in the draft legislation is too low. Although the interest and fixed charge coverage ratio analysis used in the United States is somewhat different than the analysis proposed in the draft legislation, Attachment 1 is still instructive in that it shows that the financial market is comfortable with different property sectors having a range of coverage ratios. A “one size fits all” requirement cannot reflect the subtleties at work in the marketplace. If a uniform restriction is required, we strongly urge a number that provides REIT management with the maximum flexibility in remaining competitive with the private real estate sector.

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
Executive Vice President and General Counsel

ATTACHMENT 1

Summary of Financial Leverage by Property Sector : Third Quarter 2005

(REITs and Publicly Traded Real Estate Companies)

Sector	Number of Companies	Implied Market Capitalization (Sep 2005)[1]	Debt Ratio[2]	Interest Coverage[2]	Fixed Charge Coverage[2]
By Property Sector					
Industrial/Office	34	91,391,762	40.2	3.04	2.77
Office	21	59,232,759	41.9	2.75	2.57
Industrial	7	20,490,310	39.0	3.57	3.17
Mixed Industrial/Office	6	11,668,693	33.5	3.63	3.06
Retail	6	93,338,260	42.9	3.02	2.73
Shopping Centers	18	35,887,097	34.6	3.52	3.16
Regional Malls	9	51,318,679	49.6	2.34	2.12
Free Standing	6	6,132,484	36.0	5.78	5.40
Residential	24	51,961,110	41.3	2.71	2.48
Apartments	20	49,600,295	40.6	2.73	2.49
Manufactured Homes	4	2,360,814	54.5	2.37	2.28
Diversified	11	22,451,648	37.0	3.40	2.44
Lodging/Resorts	17	17,243,803	42.0	2.90	2.44
Health Care	10	15,205,942	34.1	3.59	3.29
Self Storage	4	4,665,875	43.6	2.12	1.92
Specialty	5	13,864,290	24.8	4.00	3.95
Equity Totals by Property Sector	138	310,122,690	40.1	3.05	2.73
Commercial Property Financing	12	7,130,713	70.8	0.00	0.00
Home Property Financing	25	16,937,092	90.2	0.00	0.00
Mortgage Totals	37	24,067,805	84.5	0.00	0.00
Hybrid Totals	5	6,101,285	46.8	1.68	1.33
Industry Totals	180	340,291,780	43.4	2.81	2.51

Notes:

[1] Equity market capitalization in thousands of dollars, including operating partnership units.

[2] Weighted averages using end-of-period equity market capitalizations, including operating partnership units.

Source: SNL Securities, National Association of Real Estate Investment Trusts ®.