Chancellor’s Pre-Budget Statement

Two major announcements were made by the Chancellor in his Pre-Budget Statement, on 5th December 2005.

- Legislation will be proposed in the Finance Act 2006 to introduce REITs (Real Estate Investment Trusts – to be known as the "UK-REIT"), effective from 1st January 2007; and
- A consultation will commence on the introduction of a new tax – planning-gain supplement.

We shall look at each in turn.

The session today

This is an informal discussion on the proposals for the property sector in the Chancellor’s Pre-Budget Statement.

Tax is a topic that closely affects us all, and this is a good opportunity to join an informal discussion - where the emphasis will be on how it affects business, rather than a technical review of the rules.
Introduction

The Chancellor has announced that he intends to introduce REITs (Real Estate Investment Trusts):

- To legislate in 2006.
- To be effective from 1st January 2007.

They are to be known as "UK-REITs".

We have a considerable amount of the detail, because some of the draft legislation was released just before Christmas. A further update (incorporating proposals for groups) was published at the end of January. Also, many interested parties have made representations.

Whilst more has to be added and further representations still need to be made, we can see the shape of things to come. We expect more to be available in the March Budget, due on 22nd March 2006:

- There will be a facility for existing companies to convert to REIT status, subject to a conversion charge, details of which are expected in the Budget; and
- It is hoped that the government will listen and act upon certain of the representations – especially relating to gearing levels (see on).

Key Issues

- Why is this so important?
- How will the changes impact?
- Who will the changes impact?

What are REITs?

- A collective investment scheme designed to hold property in an easily marketable form, and
- One that offers tax benefits, in terms of reducing the double tax charge that affects the traditional listed property PLC.

Why are we interested?

- The market has been lobbying for this for many years, but to no great effect.
- Now we are at the end of a serious consultation period that has been on-going for the past 24 months.

How did it all start?

- Many years ago,
- But more recently there was a recommendation in the Barker Report - Review of Housing Supply – Delivering Stability: Securing our Future Housing Needs, March 2004

What are the aims?

- For the industry – see next page – "The case for REITs" and above - "What are REITs?"
- For the government – similar, but with no significant loss of tax. See next page – "Government's objectives".

Are they on-track to achieve this?

- There is a basic model that can work to a degree – in terms of it being a listed company that offers the right kind of tax benefits,
- But the conditions are such that there is a grave danger that the take-up across the sector as a whole will be poor.
The case for REITs

At a recent conference, the British Property Federation summarised the case for REITs in the following terms:

- **Macro Economy**
  Provide increased financial stability and a more efficient functioning of the financial and capital markets;
  Facilitate growth of London as European centre for REITs.

- **Savings and Pensions**
  Address the growing appetite for the asset class from institutions, charities and the private sector.

- **Corporate Occupier Base**
  Lower the cost and increase the flexibility of occupation by UK plc.

- **Built Environment**
  Provide a conduit to both raise and realise capital for regeneration, housing and associated infrastructure projects.

- **Property**
  Improve efficiency of capital allocation to property – modernise the industry.

Government’s Objectives

In a presentation made after the Pre-Budget and in the papers accompanying the draft legislation, the government summarised its objectives in the following terms –

- **Improving efficiency of property investment**
  High levels of debt financing.
  Potential for more efficient use of property.

- **Expanding access to a wider range of investors**
  Lack of choice for small investors and poor liquidity

- **Ensuring fairness for all taxpayers**
  Dealing with tax distortions, but with no overall loss of revenue.

- **Improve flexibility for tenants**
  Especially in the private rented sector.

Key conditions

Summary of key conditions

There are a series of key conditions that will apply to REITs, focusing on:

- The structure of the company,
- The nature of the activities, and
- The balance of the business.

The structure of the company

On the corporate side, some of the main conditions include:

- REITs must be companies, resident in the UK;
- They must be listed on a recognised stock exchange (which in the UK means the full list, but not AIM);
- REITs must have ordinary shares (and one class only – no “funny shares” as the HMT slides say) and its loan capital must comprise only normal commercial loans;
- They must not be close companies (broadly controlled by 5 or fewer members) and must use international accounting standards; and
- No shareholder may directly or indirectly control 10% or more of the REIT.

Public listing is one of the key features for the government, currently, as it is aimed at supporting wide access and market scrutiny. Probably, with the exception of the control test, none of these conditions cause major issues, although the representations do point to difficulties that will be encountered in the detail and the imposition of unnecessary constraints that will dilute the overall effect.
1 UK-REITs

The control test is one of the major issues. This is explored further, beyond.

**The nature of the activities**

The key tax conditions include:

- REITs must own at least 3 properties;
- None of which may account for more than 40% of the overall value (on a cost basis) or be owner occupied; and
- REITs must distribute to shareholders at least 95% of their net taxable profits (excluding capital gains) arising from qualifying property business – within 6 months of the accounting period end.

It is the 95% distribution test that lies at the heart of delivering the tax benefits (see below).

It is worth noting that the test is based on net taxable profits:

- So the REIT can in effect retain tax-free the amount that is represented by capital allowances, so effectively giving the benefit of these allowances.
- But this is complicated in terms of running parallel operations and records (see on) and there could be difficulties in ensuring that the level of net tax profits are settled by the end of that 6 month period.

Again, the representations do point to difficulties that will be encountered in the detail here, although the broad thrust of these conditions is accepted.

**The balance of the business**

This is the basis of the qualifying property rental business.

- At least 75% of its overall income must come from operating a qualifying property rental business; and
- At least 75% of the total value of its assets must be involved in operating a qualifying property rental business.

The qualifying property rental business can comprise UK source ("Schedule A business") and overseas (overseas property business), although any overseas element is likely to be subject to tax in the host jurisdiction. This could make overseas investment unattractive.

Income test – profits from UK and overseas property, net of capital allowances and interest charges. So, at this level debt is taken into account.

Assets test - values based on accounts values. IAS apply, but it may be that the choice remains to use a cost model (IAS 16)? No account is taken of liabilities secured against assets. But, at this level debt is not taken into account.

Probably, none of these cause major issues, although the representations do again point to difficulties that will be encountered in the detail and the imposition of unnecessary constraints that will dilute the overall effect.

But there are a couple further terms with respect to the business, which are causing major concerns – an income cover test and some special rules with respect to development of properties (for both see below).

There are also a series of excluded activities, which cannot form part of the qualifying property rental business, such as:

- Letting incidental to property development trade;
- Temporarily surplus business accommodation;
- Rent factoring;
- Wayleaves, gas and oil pipelines; and
- Rent for mobile phone masts.

So far as Groups are concerned, the following are the main proposals:

- The company conditions (structure of the company, above) will apply to the top co – the principal company;
- The income and assets tests will be applied at the group/consolidated level (including all 75% subsidiaries) – anything less falls outside the
qualifying property rental business, although it is possible for a consortium of REITs collectively to satisfy the tests by holding shares in a joint venture;

- The 95% distribution test will apply to all profits from qualifying activities of UK resident members of the group;
- Each UK resident member has its own exempt and residual activities, with all the accounting and compliance issues that this will raise.

There are major concerns in the representations as to how the rules will work in relation to JVs and other forms of joint investment.

Here the complaint is not so much the imposition of unnecessary constraints that will dilute the overall effect, but lack of a fully developed policy that will allow the major PLCs to continue with an important part of their business if they are to convert to REIT status.

**The basic tax benefits**

Subject to those conditions:

- The REIT will not pay corporation tax on its qualifying property rental business (income and gains);
- Instead, investors will pay tax on any distribution from the qualifying property rental business, as though that distribution represented income arising directly to the investor; and
- These distributions will be subject to a tax withholding at the basic rate – currently 22%, and thereafter to tax at the investors full rate.

Income and capital gains are free of UK tax within the REIT, to the extent that they arise within the qualifying property rental business. Although there is no requirement to distribute capital gains (as there is with the income) to secure the capital gains exemption:

- If gains are in fact distributed, they will also be taxed as income; and
- There is a facility to allow funds waiting for reinvestment to qualify as part of the qualifying property rental business for up to 12 months. To qualify, must be held in readily realizable form.

As noted above, overseas income will still suffer tax abroad. Representations have suggested that this should be creditable against the withholding tax (above), although it is difficult to see the government acceding to this as it would imply loss of revenue.

Representations have also challenged the proposals with regard to reinvestment, suggesting that the time is too short and that the income should be treated as qualifying.

The REIT will ring fence the qualifying property rental business:

- Thereby it will enjoy the tax benefits; and
- Any other profits will be taxed in the usual way (for a company and its shareholders).

Effectively, the tax exempt business is treated as carried on by a separate company.

This is the key aspect of the regime, which will address the double taxation issue, but will bring with it a whole raft of complexities.
The structuring of the business

A REIT will elect into the regime (and may elect out), but there will be tax consequences at each point.

- On electing in – the main issue will be the conversion charge (details awaited in the March Budget), but there will also be a deemed cessation of the old business and various rules applying to use of losses, capital allowances, etc;
- Assets may cross the ring fence, to/from the qualifying property business; and
- On electing out, plus there is the prospect of failure to meet the conditions, in which case REIT status will end. There are some anti-avoidance rules to prevent what HMRC deem to be avoidance.

The requirement to ring-fence the qualifying property rental business means that the REIT is in effect having to run two separate businesses in parallel, and keep records accordingly. But there are many tricky compliance issues to watch for:

- Monitoring the limits on gearing;
- Ensuring that the 10% shareholder test is not breached; and
- Monitoring the trading activities, and ensuring that only qualifying activities are within the ring fence.

Even though we are not expecting the profits within the qualifying property rental business to bear tax, there are tax aspects to other calculations:

- Such as the role of capital allowances, and
- The fact that the distribution test and the gearing test are measured against taxable profits (not accounting profits).

Issues that give most concern

There are three issues that are giving the industry cause for concern:

- First, that no one shareholder (directly or indirectly) is allowed to control 10% or more of the REIT;
- Second, the income cover test; and
- Third, rules with respect to developments.

10% shareholding test

The 10% test is there to ensure that overseas shareholders cannot claim the benefit of double tax treaties to eliminate the UK tax liability on distributions. As it is UK source income, the REIT will be required to withhold at source income tax at the basic rate (22%).

- There are fears that this test will prevent a number of existing PLCs from converting, and
- That it will raise tricky issues on flotations. There is often a requirement for significant shareholders to remain post float.
- But – how will it affect new funds that are designed to accommodate a multitude of small investors? Maybe this is the area where REITs can be successful, but we shall need to ponder other areas too – such as the income cover test.

It is felt that this condition is non negotiable, as the government is anxious that REITs should not be modelled in a way that would lead to a cut in the UK tax take from property. Hence, this condition might reduce the initial success of the REIT in the UK market. If the condition is breached, the company will fail to qualify as a REIT.

Industry groups are trying to persuade the government instead to negotiate changes to the relevant double taxation treaties – to exclude the benefit of the treaty from income arising from a REIT (so that the treatment that they would expect from a direct holding of property would be replicated). There is very little prospect that they will agree to this.

Income cover test

The income cover test is one of the key features for the government, currently, as it is aimed at promoting equity-based vehicles with sufficient flexibility.

The income cover test may still be negotiable, and interested parties are making representations here.
1 UK-REITs

- Essentially, the test is that financing costs must be covered two and a half times. This implies that the gearing cannot be set above 40%. That in itself is low.
- However, the test is applied to taxable profits, so that estimates suggest that the actual rate will be under 40%.

It is financing costs, not just interest. Includes interest, exchange gains from debt, profits from derivative contracts in relation to debt, finance costs under a finance lease and other costs that would be considered, in accordance with GAAP, to be a financing transaction.

This is not in fact a condition, in the sense that if it is breached the company does not fail to qualify as a REIT. Instead, the REIT will be subject to a tax charge on the excess, but the details of this charge will be released with the March Budget.

Alarmingly:
- No listed company would presently satisfy the income cover test, and the UK listed sector has never reached this level.
- Also, the test will fluctuate with the level of capital allowances, etc and other factors.

Using capital allowances in the test means that there will be significant differences between different sectors (based on the extent to which they can claim allowances) and significant volatility.

The interplay between income and financing costs means that the activity of REITs will be constrained. For example, development of buildings (and thereby improvement of properties) is penalized, as the income will dry up and costs (and hence the borrowings will increase).

There is a feeling that REITs will not succeed if this level of income cover remains. It is certainly the case that the representations from the listed sector see this as the overriding issue with the rules as currently drawn.

But, again - how will it affect new funds that are designed to accommodate a multitude of small investors? Will it materially affect their return if the REIT is less heavily geared than existing models? So, whilst the new funds might not have an issue with the 10% test, will they have an issue here?

If this is an issue, what are the solutions? Here are a few that have been suggested:
- Drop the interest cover test entirely (as it is not adopted by any other REITs worldwide) or replace it with a loan to value test (LTV);
- Re-capitalise existing structures? It is estimated that it would take a collective rights issue of £10 to £15 billion for UK Property PLC to hit the test;
- Alternatively, properties could be sold, or higher yields/rents sought.

The industry hopes that other tests or thresholds might be adopted.

The irony of that is that goes against some of the commercial objectives that the government has. For example, on the one hand this is driven (supposedly) by the idea of reducing gearing in the sector, but it is residential property that produces one of the lowest yields. Hence, it has been suggested that the effective gearing in this sector would be as low as 20%.

Yet this where the modern history of REITs started – one of the recommendations in the original Barker Report was to look at the introduction of REITs, to encourage the residential rental sector. At these levels of gearing, the REIT will not be an attractive investment option and fund managers will look elsewhere for their corporate structures.

Also, representations point out that the rules might actually encourage REITs to seek high yielding properties to minimise the impact of this test – resulting in the sector concentrating on risky or low quality property investments.

So, is there a risk that the market will take the view that existing structures are preferable? Clearly, so there is a hope and expectation that lobbying will succeed here. Time will tell.
1  UK-REITs

**Issues with respect to developments**

Broadly:

- Development is allowed for the purposes of investment within the qualifying property rental business;
- But there will be a charge to tax if the property is then sold within 3 years where the property has been developed since acquisition and the cost of development exceeds 30% of the cost of acquisition.

Representations again challenge the government here, but the net result may again point to the fact that REITs are not for the traditional UK property PLC, which mixes development and investment.

Maybe REITs are fit only for holding investment properties that need very little further development.

UK property yields are comparatively low (because rental income is relatively secure);
But interest rates are relatively high; and so
Spreads are low but other costs are similar.

- £10.2 billion of debt would need to be replaced by equity (32% of property sector market capitalisation) to meet interest cover test (Source: UBS Investment Bank).
- Only 40% of leading property companies meet the 10% individual shareholder limit (Source: UBS Investment Bank). Property companies have no control over investors’ behaviour.
- Only one class of ordinary shares permitted. A number of listed companies have different capital structures. For example:
  - Liberty International has convertible bonds;
  - Slough Estates has preference shares; and
  - Land Securities had non-voting shares until 2004.
- Distribution policy – many listed companies do not adopt a near maximum dividend distribution policy.

**Commercial structuring**

*Will many listed companies convert into REITs?*

The signs are not positive:

- Conversion charge unclear (detail awaited in the Budget)
- “We believe none of the quoted property companies could currently meet the [interest cover test]” (Source: British Land). This is because:
1 UK-REITs

Impact on investment policy

Will the income gearing test:

- Limit residential investment which is the lowest yielding sector (but the most popular sector for US REITs);
- Encourage investment in secondary/tertiary property which normally has a higher yield, but may not be suitable for retail investors; and
- Encourage a reduction in debt maturity, which is normally lower cost assuming a positive yield curve.

Will the rules adversely affect the development and improvement of property investments?

- 3 year rule on the sale of development properties, but
- Property under development by definition does not generate income, so affecting the income tests.

Will the IPO market/M&A market for REITs prosper?

The main concern here is that the shareholding restrictions will impact adversely on IPOs:

- 32 public to privates since 2000 – MEPC, Chelsfeld, NHP etc;
- There are normally restrictions on sales of shares by vendors into and after the IPO;
- Of the 100 IPOs in 2004 and 2005 only 19 had free floats of > 90% (Source UBS Investment Bank);
- No individual shareholder restrictions in France/Australia – less restrictive regime applies in the US; but
- This may be less of an issue for new managed funds?

So far as M&A transactions are concerned, there is a concern that the shareholding restrictions and the income gearing rules will impact:

- Income gearing limit may make cash bids by REITs difficult. Cash bids account for most takeovers;
- The shareholder restriction may make share offers by REITs difficult (as the vendor may hold >10%) although schemes of arrangement to effect mergers of REITs may work; but
- Successful US and Australian REIT markets characterised by high level of M&A activity.

Will offshore centres still be used?

Jersey, Guernsey, IOM are still likely to be popular. There has been a £25 billion plus inflow in recent years.

- Jersey Property Unit Trusts (JPUT):
  
  Are tax transparent if established as "Baker Trusts" in which income vests as it arises;
  
  The trustee of the JPUT is exempt from UK CGT on the sale of property if the JPUT is managed/controlled offshore; and
  
  Currently the transfer of interests in UK property into the JPUT and transfers of units in the JPUT are outside the scope of SDLT. This may change at the next Budget on 22 March 2006.

- Offshore REITs:
  
  No gearing limits or maximum percentage holdings or minimum level of distributions;
  
  No restriction on type of business; and
  
  Relatively simple regulatory process.

See also sections beyond:

Comparison with other jurisdictions
Comparison with other structures
1 UK-REITs

Listing and other legal issues

- Prospectus will be needed:
  For a listed property company to list more/a different class of shares unless it only increases a class of its already listed shares by less than 10%;
  For an unlisted vehicle to obtain a listing irrespective of whether a public offer is made (not the position for a float on AIM);
  To come to listing on the usual basis (if well established) or [modified] Chapter 15 type basis (if not); and
  Accounting/other information must be prepared. Note: requirement for IAS information.

- It may be necessary to rationalise the property portfolio to ensure:
  The ring-fenced business is at least 75% of total.
  Development divisions may need to be demerged; and
  The 40% of value single property limit is observed.

- A rights issue/placing/offer for sale etc may be needed:
  To avoid “close” company status;
  To avoid breach of individual shareholder limit; and
  To avoid breach of income limit.

- A capital reorganisation may be needed, as only 1 class of ordinary share will be permitted.

- Constitutional/other documents may need to reflect conditions:
  Articles of association to contain provisions:
    Prohibition on 10%+ shareholdings provided Listing Rules permit. Remember the early ‘privatisation’ stocks;
    Requiring 95% plus dividend distribution policy; and
    Limiting borrowings to income gearing limit
  Facility agreements to contain income gearing covenants.

- Ongoing obligations:
  Listing/disclosure rules will apply
  City Code applies – but no takeover premium

New Funds

- Attitude of large fund managers is key.
  “It is as good a structure as in the rest of the world” (Jeff Schwartz of Prologis - reported in FT on 8 February).

- Latent potential:
  “… under the right conditions, estimates envisage an additional $100 billion entering the listed market in the next five years” (Source: EPRA – based on UK and German market only).

Round up of other points

Comparison with other jurisdictions

There are some interesting comparisons to be made with REITs in other jurisdictions -

In the US –

- The total value of the REITs market is now well in excess of $300 billion.
- The market is very sophisticated, and is something for the UK to aim at.

REITs have also successfully been established in –

Australia (the listed property trust), France (SIIcs) and Canada.

It is worth doing a trawl of the internet to see –

- The REITs that exist overseas; and
- The overseas markets in REITs.

The government suggests that their proposals for REITs are on a par with those in other key jurisdictions, but how do they compare?
A view of REITs in other jurisdictions

If the proposals for REITs are on a par with those in other key jurisdictions, how do they compare on the issues that cause most concern?

This table compares some of the key features across five jurisdictions.

<table>
<thead>
<tr>
<th>Feature</th>
<th>US</th>
<th>Australia</th>
<th>France</th>
<th>Canada</th>
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* Detail still awaited.

Comparison with other structures

Where will the market for REITs lie? Maybe one can get some clues by looking to see how they will appeal to different shareholder groups, and what are the main alternatives.

Although a choice may not be entirely tax driven, it is worth looking at a comparative table of the tax position.

This table assumes that:

- The income/gains are distributed to the investor; and
- The holding is under 10%, which provides a proper comparison to a REIT.

10% is the threshold that allows an investor to claim double tax relief

- Either in some cases to reduce the level of withholding tax on income (when an overseas investor invests into the UK); or
- To give a UK company credit for underlying tax paid by an overseas company; and

We do need to be careful though when making the comparison.

- When account is taken of gearing, existing structures can be made to work better for certain shareholders as it reduces the amount of income and increases the effective gain.
- Also, the impact of capital allowances will have an effect.
## UK-REITs

Assessment of how far we have moved?

There is still a lot of uncertainty surrounding REITs.

- It is good to have got this far, and we hope that the government will listen to the genuine concerns of the real estate sector.
- However, it may be that the regime will be launched in accordance with these terms and conditions (perhaps with the income cover test relaxed) and that we shall then have to wait to judge the level of the take up.

It will nonetheless be a start. Thereafter we can perhaps hope for changes that will improve on the model over time - maybe relax the income cover test (if not already done) and in time to extend the regime to AIM companies and possibly even unquoted companies.

It would be usual to expect regimes such as this to evolve over time. One commentator made the point that US-REITs have been around for over 40 years, and that the UK proposals might take the UK-REIT 30 years down the line. If so, that would be an achievement.

We shall await with interest what comes out in the Budget, now due – 22nd March 2006.

But, in a presentation made after the Pre-Budget, the Treasury said:

- "Key policy decisions on structure have been made"; and
- "Moved into a technical HMRC led consultation".

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<table>
<thead>
<tr>
<th>Holding –</th>
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<th>Pension fund</th>
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<tr>
<td>Income</td>
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</tr>
<tr>
<td>Gains</td>
<td>40%</td>
<td>30%</td>
<td>nil</td>
<td>22% [3]</td>
</tr>
</tbody>
</table>

[1] Full rate, subject to taper relief.
[2] Effectively the same as the income line, if distributed.
[3] If distributed, but nil - if sell shares and REIT has not distributed (and gain reflected in share price).
The government feels that it is there, as they see the proposals as striking a balance between market flexibility, delivering objectives and protecting the Exchequer.

And mixed messages are coming from the industry. Some of the public/press comment is critical in the key areas, whereas other comment is more supportive.

Revisiting the key Issues

The key issues identified at the start were -

Why is this so important?

- The hope is - it is likely to lead to the biggest shake up in the property sector for many years.
- Are we there? Not yet. It seems likely that REITs may be subject to a slow initial take-up whilst the government is persuaded to loosen the conditions to make them truly attractive to the whole market. In the meantime there may be some take-up for certain sectors of the investment community.

- Are we there? Again, not yet. The government has added too many conditions that will leave many feeling that existing structures offer greater flexibility. Again, it may suit some sectors of the investment community.

Who will the changes impact?

The changes would impact across the whole property sector – if we get what we have lobbied for, a vehicle that combines tax efficiency and ease of investment will be available to the market:

- Existing property companies would have the opportunity to convert into REITs, and thereby address the discount to net asset value;
- New property funds would launched, reversing the retreat of listed property companies and adding liquidity to the market;
- The trend for companies to take property assets off their balance sheet may accelerate, as property occupiers have the chance to float off property holding funds.

Opportunities would abound for all interested in the property sector. But if we do not get the right structure:

- Which segment of the market will be interested?
- Are we there? Not yet.

How will the changes impact?

- The hope is - by removing the double taxation that exists in companies, and offering a tax treatment that equates to holding property directly, the establishment of many more collective property investments will be encouraged.
- Are we there? Again, not yet. The government has added too many conditions that will leave
2 Planning-gain supplement

Introduction
The Chancellor has issued a detailed consultative paper that looks at the introduction of a planning-gain supplement (PGS).

- There is a pledge in the paper that it would not be implemented before 2008, and,
- If it is, it will "be set at a modest rate to capture a portion of the land value uplift created by the planning process".

This session looks at the proposals as outlined in the consultation paper. It will be interesting as the consultation develops to see what other participants in the sector make of the proposals and the overall direction of government policy in the area of planning and real estate generally.

The aim of PGS is:
- To help to fund infrastructure projects,
- Whilst preserving the incentive to bring land forward for development.

But, it is still a tax - so it remains to be seen what impact it may have on the market and whether it will preserve or harm the incentive to develop.

Key Issues
The questions that we need to examine are these:
- Who will the changes impact?
- How will the changes impact?
- Why is this so important?

Barker Report /History
The idea has its roots as one of the proposals suggested by Kate Barker, in her review of housing supply Review of Housing Supply – Delivering Stability: Securing our Future Housing Needs, March 2004.

She suggested the introduction of a new tax on residential development, where gains through the grant of planning permission are so substantial. She called this a Planning-gain Supplement.

We now seem to be at the point where it is suggested that we could see a return of development land tax, or something similar - not just restricted to residential development.

Some statistics from the Consultative Paper
The Consultative Paper contains a variety of figures to justify the approach, illustrating the very significant increases in values from agricultural land to various forms of development land.

Other sources contain other interesting references.
- For example, one commentator calculated the total land value increase that arose within a radius of 1,000 yards of each of the new Jubilee Line extension stations.
- His conclusion was that these land values alone, increased by a £13billion when the construction cost of the line itself was only £3.5billion.

Don Riley, article can be viewed by clicking here

Useful cross references - in the Consultation Paper, relative to the Barker Report and the table of values adopted by the Treasury, can be found at paragraphs 1.5 to 1.10.
2 Planning-gain supplement

Stated principles and objectives
The government state a number of objectives against which PGS and a scaled back 106 arrangement will be assessed:

- To finance additional investment in the local and strategic infrastructure, to support housing growth whilst preserving the incentive to develop;
- To help local communities share better the benefits of growth and manage its impact;
- To provide a fairer, more efficient and more transparent means of capturing a modest proportion of the land uplift value; and
- To create a flexible system that responds to market conditions and does not distort development decisions between different types of development.

Other ideas over time
This has been a well-trodden area in the past.

- The last was DLT, and before that development gains tax;
- Kate Barker suggested an alternative – an optional planning charge;
- There has been a strong lobby over the years for the UK to adopt a full land value tax, based on economic arguments; and
- Other input into the debate, most recently the National Institute of Economic and Social Research. But a lot of press comment too – not just in the property press.

Useful cross references - in the Consultation Paper, relative to some of these issues, can be found at paragraphs 1.15 to 1.19.

Valuing planning gain
The favoured idea is to tax the difference between the planning value (PV) and the current use value (CUV).

The government intends it to be a self assessment tax, and so proposes that the requirement to carry out valuations will fall upon the chargeable person.

However, maybe the tax itself would be deferred until the development commences to avoid cashflow difficulties.

Key formulae:

- Uplift = PV – CUV
- PGS = [PGS rate] x Uplift

What will the rate be? We are told – "modest". The only printed suggestion to date - at 20%.

Useful cross references - in the Consultation Paper, relative to some of this, can be found at paragraphs 2.5 to 2.6.

The paper then looks at the detail of whether its calculation would be linked to full planning permission. CUV is likely to equal the value the moment before full consent granted (or the last of any reserved matters approved).

Paying planning-gain supplement
At this point the Consultation Paper raises a series of propositions on some key issues, but it seems that the government has a pretty clear idea what it wants. The issues are:

- Who should be liable to PGS; and
- How might it be enforced?

It is quite possible that the charge will accrue whilst the land is in the ownership of an initial owner, who will then sell it before the start of the development.

In that way, the charge would most likely fall on the purchaser, the developer at the start of the development, who would then be obliged:

- To serve a development start notice on HM Revenue and Customs/Local Authorities.
- The PGS would be enforced through interest charges, penalties and perhaps in extreme cases, by the service of development stop notices.
2 Planning-gain supplement

One of the challenges that the government already recognises is that they must deal with the devolved administrations, particularly in Scotland and Wales. They have to reach accommodation with them, and also the local authorities within England and Northern Ireland. All of these parties will have a role to pay in the administration of the system, and will be major recipients.

The proposal is that the charge would fall on the "active party" – i.e. the party doing the development. This is illustrated in paragraph 3.9 of the Consultative Paper by a simple flow chart.

There will be a range of current transactional issues to contemplate, and sooner rather than later.

- If the tax gets up and running, there will be important issues to deal with in the sales process and in the valuation of the sale to the developer.
- In some cases, the charge may have arisen (albeit that it has not yet been paid), as the latent charge may transfer to the developer – the "active party".

This links into the whole question of transitional issues. Proposals are thin here, save that:

- The government has said that it will wish to minimise opportunities for avoidance, and
- That even if the charge does not come in before 2008, it is possible that it will apply to planning permissions before that date.

All that the Consultation Paper says is that it is envisaged that planning permissions granted before a particular date will not be subject to the levy.

- What if you buy some land from a farmer and agree to pay an overage based on planning permission that may be granted some years off?
- The drafting and calculation of the overage needs to cover the possibility of this tax. Hopefully a lot of drafting will, but some will not.

We need to be mindful for the future.

Scope

It would appear that the government intends that PGS will apply to residential and commercial development, although the original Barker Report (which first raised the idea of PGS) was concerned with issues surrounding residential development.

It is proposed not to apply to home improvements. Whilst that is welcome, if they had to say it (by way of an exception), it merely underlines the fact that it will be charged on everything else that moves!

The basic proposition is that:

- There will be a single rate that applies to all types of development,
- Save that the government will consider a lower rate for brownfield sites.

The government is minded to have a low threshold and few exemptions, so we do have the prospect of a wide-ranging tax in its scope.

Finally, it is proposed that the tax will not be credited against other taxes, but will merely be a business expense for the developer. By definition this forces up the effective overall rate of tax on the transaction.

Financing infrastructure

In tandem with the introduction of a PGS, the Government is also planning to review the financial contributions paid by developers under planning agreements, which are currently entered into to secure the grant of planning permission.

The tax will replace significant parts of the arrangements that are presently covered by s106 agreements.
2 Planning-gain supplement

Chapter 5 of the Consultation Paper:
- Starts with the original Barker recommendation,
- Moves on to review the current system and the novel approach adopted by Milton Keynes (effectively priced at £18,500 per dwelling), and
- Proposes a new development site approach.

Useful cross references - in the Consultation Paper, showing the original Barker recommendation and the new proposed development site approach, can be found at paragraphs 5.2 and 5.15 to 5.16.

Allocating revenues
The paper then goes on to look at how these revenues will be used to finance infrastructure projects and how they will be allocated, particularly to the authorities covering the area where planning is awarded.

The basic proposals are that the overwhelming majority of the proceeds will be recycled within the region from which they derived. There are two options:
- First – a return to the local area in which the development occurs via a grant in direct proportion to the way the revenue was raised; or
- Second – by way of grant, but via a less transparent formula.

But whilst the majority of the proceeds will be recycled within the local area, the paper also holds out the idea that a significant proportion would be used to deliver strategic regional projects.

Conclusion
- The first round of consultation drew to a close on 27th February, but if the tax is not to be introduced until 2008, does that mean that there should be of a long overall consultation period? Not necessarily –
- A tax introduced in 2008 might still catch planning permissions granted before that date (albeit not before today);
- So, we need to start planning now.

As with any tax, there may be opportunities to avoid or mitigate it by starting or planning developments ahead of its introduction. It is essential that thought is given to it now, for any relevant land transaction.

There are aspects to the consultation that suggest that we need not necessarily fear the worst –
- Such as setting the tax "at a modest rate", and the implicit suggestion that it may replace the arbitrary aspects of the s106 process.
- Having said that, when did we ever really welcome the introduction of a new tax?

The property sector on balance remains opposed, and needs to work hard at ensuring that its views are heard. Others are more in favour, and their voice will be heard too.

Will it survive a change of government? Often the measure as to whether development will continue to be encouraged

Back to the key Issues
The questions that we need to examine are these –
- Who will the changes impact? – All of us.
- How will the changes impact? – It will apply to most planning gains.
- Why is this so important? – We need to start thinking about it now

A reminder of the main features of the PGS, can be found in the Consultative Paper, at paragraph 1.3.

The Consultative Paper itself can be accessed from the HM Revenue and Customs website – click here.

Or if accessing though the home page – click here
Put in a search "planning-gain", and it should lead you to the same place.