

Destination UK:

International Property Investment and the Role of Taxation

Executive Summary
March 2000

Research conducted by:



Sponsored by:



Mishcon de Reya Solicitors

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The College of Estate Management is the leading international body providing distance-learning education, training and research for the property and construction professions.



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Helical has a £1 billion development programme, which has over the past five years produced £70 million of profits, and a £400 million investment portfolio. Its strategy is, by anticipating changes in the market, to use the substantial cash flows from developments to acquire investments in the better performing market sectors.

*Source: HSBC 6.1.2000

Mishcon de Reya Solicitors

Mishcon de Reya is a 29 partner law firm based in Holborn. Its Property practice acts for property companies, developers and investors.

Grant Thornton

Grant Thornton is a leading financial and business adviser to owner managed businesses and their owners. It aims to help them realise their ambitions locally, nationally and internationally - via a UK network of 43 offices and an international network with representation in over 100 countries.

Introduction

The results of this independent research project were released in March 2000. It was carried out by The College of Estate Management, Reading, jointly funded and supported by Helical Bar, law firm Mishcon de Reya and accountants Grant Thornton. The Investment Property Forum Educational Trust also took a keen interest in the project.

Why this research?

This research was undertaken to seek answers to two questions of mounting interest to all those who invest in commercial property:

- Do foreign investors in UK property enjoy tax or other advantages over UK property companies which enable them to outbid their UK competitors?
- If such advantages do exist how can UK property companies redress the balance and compete in future?

What are the findings?

Four main conclusions are drawn from the evidence:

- The UK property market suffers from a severe lack of liquidity. This will continue whilst UK property companies suffer double taxation of their income and the discount to net asset value at which their shares trade on the stock exchange.
- Serious inequalities exist between the main asset classes particularly in terms of their tax treatment and overall transaction costs. Tax differentials distort investment markets and run counter to policies aimed at improving efficiency and economic welfare. In this respect, property suffers a disadvantage compared with other assets.
- The UK tax regime offers a clear competitive advantage to overseas investors in the UK, who enjoy both a lower overall burden of taxation here and some positive tax discrimination. Their interest in the UK market, however, makes a significant contribution to its liquidity.
- The trend towards indirect investment in property through REIT-type companies, limited partnerships and other securitised vehicles enjoying tax transparency poses a threat to the future of the UK property company in its present form.

Why do we need property companies?

Property companies offer an investment channel which no other type of organisation has so far matched.

Investors benefit from management expertise in asset selection, resulting in portfolios of high quality properties. Gearing, which raises returns in a way that the regulations governing REITs and similar vehicles do not permit, provides additional benefits, as does the liquidity of stock market investments.

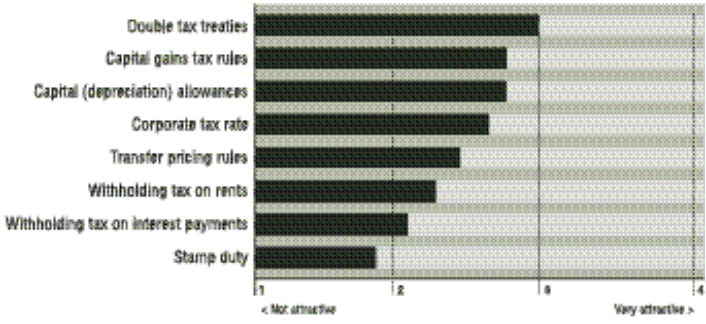
Property companies have also performed a crucial role in property development and investment in the overall economy.

To remain in business, however, property companies have to earn returns above those of their competitors in order to redress the imbalance between their tax burden and that of their overseas competitors.

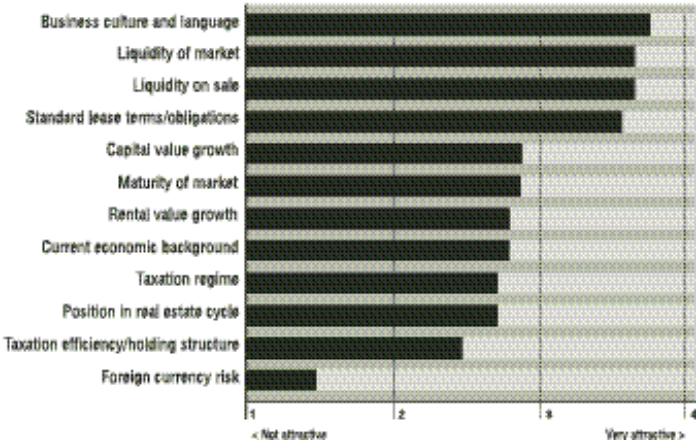
What are the attractions of the UK property market for foreign investors?

The mid to late 1990s have seen mounting interest from overseas in UK property, which in this period, was the most popular European destination for property investors. Germans were attracted by UK lease structures and market characteristics. US investors have come for risk-adjusted returns which were higher than those obtainable in the US market. Other investors came for the stability of the market, familiarity of the culture and the strength of the economy.

Attractiveness of UK Tax Components



Attractiveness of UK for Foreign Property Investors



Generally the prime attractive force has been the quality of the market, and in particular, the depth and sophistication of the London property market.

Once an investment decision has been made, overseas investors benefit from a liberal tax regime. Levels of corporate and personal taxation in the UK are perceived as among the lowest in Europe, and specific features of the tax system favour the overseas investor.

Further benefits have arisen from double tax treaties leading to ‘treaty shopping’, inter-state differences in regulations governing tax relief on qualifying debt interest, and the ability to finance investment in the UK from abroad. There are therefore effective tax shelters for UK rental income.

How are investment markets distorted?

A wide disparity now exists between the duty levied on UK property transactions and that borne by transactions in other assets. This has certainly contributed to the popularity of the equity market generally, and bears some responsibility for the inflation of share prices.

Higher transaction costs reduce liquidity as transactions become more widely spaced. Liquidity is further reduced where overseas investors are deterred by the premium they have to pay. Incoming US investment is particularly hit by the rise in UK stamp duty, a more sensitive issue for Americans since there is no federal tax on property transactions.

The rise in transaction costs has contributed to the difficulties of UK property companies in raising new capital, as the liquidity of their shares has declined.

The relative tax burden on property transactions is higher in the UK than elsewhere in the EU. For transactions in financial assets it is currently one of the lowest.

Is the UK a tax haven for foreign property investors?

The report concludes that the UK offers some special tax advantages to foreign investors. This occurs partly because the rates of corporate taxation generally are lower than those elsewhere and partly because foreign investors enjoy significant concessions.

Some UK tax arrangements give preferential treatment to non-resident investors. Immunity from capital gains tax and the freedom to set interest on non-UK borrowing against the withholding tax on rental income are leading examples. The profits from land deals enjoyed by non-resident trading companies may be protected from UK corporation tax by double tax treaties or through the issue of discount bonds.

Overseas investors in UK property can exploit offshore vehicles. Limited partnerships of US investors enjoy tax advantages by investing through controlled companies in the UK. The UK itself is a tax-efficient, offshore location for investment in other countries, particularly those of the EU.

The attractions of a tax efficient UK market for non-resident investors bring greater liquidity, serving the interests of UK resident investors, but give non-residents a competitive edge in bidding for properties.

Why securitisation?

Improved property market liquidity in the UK awaits the emergence of a large tax transparent vehicle issuing securities tradeable in secondary markets to a wide investor base. Limited partnerships do not perform this role fully in that their investor base has been restricted and their 'shares' are non-tradeable. Future reform may address these problems.

Treasury reluctance to support legislation sanctioning such vehicles in the UK has been a further reason for the institutions' disenchantment with property. Without a resurgence of the institutions' interest, the UK property market will continue to be starved of liquidity.

Although large tax transparent REIT type vehicles might re-activate the interest of UK institutions in the property market the models researched have some limitations. Gearing, investment portfolios, share ownership, and profit distribution are governed by tight restrictions. The stock market performance of REITs and SICAFIs also appeared to be more volatile and require higher returns than that of the market as a whole.

How will EU tax harmonisation affect property markets?

Despite the decline in the value of the euro the use of the single currency has lowered transaction costs and promised to expand cross border trade and investment flows. In turn this gives rise to a move for tax harmonisation.

Any future EU tax harmonisation policy which raised UK taxes to a higher European norm might reduce the levels of inward investment with further effects for liquidity.

There is reason to believe rate revisions could well be upward. The unreconstructed social welfare economies of continental members require higher tax rates than those of the UK to maintain their levels of social support, certainly in times of economic stagnation. The attempt in 1999 to raise the UK withholding tax on interest payments from zero to 20% offers another indication of this trend.

What is the future for property companies?

Currently, property companies in the UK are disadvantaged by the differentiating tax regimes applied to corporate and unincorporated investment organisations. In the absence of strong institutional interest, property development and investment depends more heavily on their entrepreneurship. Their tax status, however, exacerbates their difficulties in raising new capital.

The research suggested that barriers between European markets would continue to fall and pan-European tax efficient securitised investment vehicles would emerge. These might still be subject to the kind of restrictions that control REITs and SICAFIs.

In this environment a strong theme in the research was that listed property companies, fewer in number, could operate alongside such vehicles, focusing more on development, redevelopment and refurbishing, and exploiting the new profit opportunities these vehicles offered. This pointed to a more specialised role for property companies as venture capital organisations engaging in highly geared, high margin activities.

Future property investors would probably have to be more client-oriented, since accounting and business changes were pointing to a more flexible property market.

Methodology

The research was carried out by the College of Estate Management, Reading during 1999-2000 and comprised the following stages:

- Postal questionnaire survey of overseas property investors from USA, Germany and the Netherlands, and UK-based property advisers;
- Face-to-face interviews with real estate specialists from a variety of disciplines; and,
- Two focus groups with specialists in the field to address key research questions.

For further details about the research, please contact:

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A full report will be available from the College's Publications Department (Gill Crew) in early March.

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