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Mr J Swinney
Deputy First Minister
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The Scottish Parliament
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By email: John.Swinney.msp@scottish.parliament.uk

1 May 2015

Dear Mr Swinney

Need for LBTT relief on converting an existing property unit trust to a property authorised investment fund

The Association of Real Estate Funds[1] is writing to express concern that there is no relief from LBTT when an existing authorised unit trust invested in property converts to a property authorised investment fund (PAIF). This is a particular problem for both Scotland based property funds and funds with Scottish property. Property funds based in Scotland often have a Scottish fund manager.

The importance of PAIFs

Investment funds are an essential savings vehicle, particularly for smaller savers and investors that otherwise lack the scale necessary to access the capital markets. To be an effective means of saving, fund structures must provide investors with the same tax treatment as direct ownership of assets.

A PAIF is a type of authorised fund designed for investors wishing to invest in property. The PAIF regime was launched in the UK in 2008. To date, as far as we know, eight PAIFs have launched. Three of these are based in Scotland. Two are managed in Edinburgh and the manager of the other is based in London and Edinburgh. A number of members are currently involved in converting existing funds to PAIFs.

PAIFs invest mainly in property or shares in UK REITs or overseas equivalents. The PAIF regime ensures that investors in PAIFs are taxed in a similar way to those that invest directly in property. This is achieved by means of an exemption from tax on rental income and gains within the PAIF whilst distributions from the PAIF retain the character of the underlying income. This means that investors are treated as receiving property income in relation to the proportion of property income derived from the underlying assets. In contrast, the rental income of an authorised fund which is not a PAIF is taxed within the fund itself.

Generally speaking, PAIFs are a more attractive option for investors wishing to invest in property. This is particularly true for non-taxpayers, including charities, pension funds, life companies and

[1] The Association of Real Estate Funds (AREF) represents the UK unlisted real estate funds industry and has about 70 member funds with a collective net asset value of over £50 billion under management on behalf of their investors.

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ISA investors, because they achieve the same tax result by investing in a PAIF as they would by investing directly in property.

The need for relief from LBTT

A PAIF must take the legal form of an open-ended investment company (OEIC). An authorised unit trust (AUT) that invests in property cannot benefit from the PAIF regime without first converting into, or amalgamating with, an OEIC. This entails property and other assets being transferred from one legal entity to another.

Property transferred from an AUT to an OEIC for the purpose of converting into a PAIF is exempt from SDLT (SI 2008/710). However, there is no equivalent relief from LBTT for property situated in Scotland and this is a barrier to conversion.

You can find further detail on the need for relief in the Appendix.

We urge you to consider this matter quickly. Lack of a relief from LBTT is delaying some conversions and we understand that the Scottish Government is already aware of this. The conversions may ultimately go ahead, but possibly divested of Scottish property.

Lack of relief may disincentivise funds from investing in Scottish property and have a negative impact on the Scottish property market. Also, the Scottish property industry and Scotland based funds could be disadvantaged compared with those based in the rest of the UK and elsewhere.

I look forward to your response. In the meantime, if you require any further information, I am available at your convenience.

Yours sincerely

John Cartwright
Chief Executive
The Association of Real Estate Funds

cc: Sean Neill (Scottish Government)
Colin McHardy (Revenue Scotland)

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Appendix

Scotland – Land and Buildings Transaction Tax (LBTT)
Property Authorised Investment Funds

Introduction

This note considers a specific urgent issue with property authorised investment funds (PAIFs) which focus on investing in interests in land and buildings (referred to as 'property' in this note) and LBTT. All references to 'authorisation' or to 'authorised funds' are to Financial Conduct Authority (FCA) authorisation.

Where relevant it also makes comparisons with the issues arising with Stamp Duty Land Tax (SDLT) in the rest of the UK (rUK).

The FCA permits a specialist structure within the authorised fund regime – the property authorised investment fund (PAIF). Under UK rules a PAIF is exempt from direct taxes on its property investment business provided that it meets certain conditions. A PAIF distributes property income dividends (PIDS) which are treated in the hands of the investor as being income arising from UK property and are subject to deduction of UK rate basic rate income tax at source (the Scottish rate does not apply to PIDs paid by PAIFs or by UK REITs). As an opaque fund the PAIF is the beneficial owner of the property it holds and so pays SDLT or LBTT on acquisition and, on a disposal by the PAIF of property, the buyer of property is responsible for SDLT or LBTT as appropriate.

PAIFs are open-ended investment companies within the charge to corporation tax and so are opaque for tax purposes. A PAIF is authorised as a NURS (non-UCITs retail scheme) or a QIS (qualified investor scheme) by the FCA.

The purpose of the PAIF structure is generally to move the point of tax to the investor so that each category of investor is taxed on property investment according to that investor's applicable tax rates – much as if they held a direct investment in property.

A PAIF may have anything from a small number of large investors to many thousands of retail investors each with relatively small holdings. The fund acts as an efficient conduit for channelling investments into property and for giving investors access to returns from holding property whilst spreading risk.

The issue

A particular problem has arisen in respect to LBTT (but not for rUK SDLT as explained below) where an existing property unit trust is to be converted to the PAIF legal form. The PAIF legal form has become increasingly popular recently as a method of giving appropriate returns to a variety of investor types from a single fund enabling more efficient pooling of assets while spreading risk across properties.

A PAIF has no particular issues with holding Scottish property for LBTT (or rUK property for SDLT) as the fund is a legal person and so is capable of beneficially owning property and will be the person liable for any LBTT charge on its purchase of property in Scotland. It follows that investors in such a fund will not need to consider dealings LBTT on account of their investment as they hold shares in the fund and not interests in property.

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However, this does lead to a specific issue when a PAIF (or other fund treated as a corporate for LBTT and SDLT purposes) is established using an existing property portfolio as the transfer to the fund of the property portfolio would normally lead to an LBTT charge in respect of property situated in Scotland even though there is no economic change of ownership (ie it is effectively a second tax charge on property they already own). This acts as a tax barrier to establishing new property funds despite this being an efficient way of making funds available for property investment.

SDLT as it applied to the whole of the UK until March 2015 and as it continues to apply in the rest of the UK has a 100% relief in place for property portfolios transferred from a unit trust to an open-ended investment company which covers, for example, conversion of an authorised unit trust into a PAIF. The existing relief for SDLT was introduced in 2008 when the PAIF tax regime was introduced and is set out in United Kingdom SI 2008/710. No similar relief appears to have been provided for in the case of LBTT.

In general existing reliefs applying to SDLT have been replicated for LBTT but this has not, and we are not aware of any policy reason why this should be so. We had expected that it would be replicated along with other reliefs and, in particular, *there are large fund conversions, currently in late stages of planning, which are likely to be seriously affected if there is no LBTT relief in place*.

If there is no relief for LBTT then these conversions may not go ahead for funds with material investments in Scottish property, at least one such conversion already having been delayed pending clarification of the position.

Further related issues

In addition to the existing relief for SDLT in respect of rUK property, the UK Government has consulted on extending the relief for establishing PAIFs to property portfolios that may originate from wider sources than existing unit trusts and has now confirmed their intention of legislating to achieve this objective.

The UK Government consultation also covered the issues arising in respect of the SDLT treatment of property held subject to tax-transparent fund structures and we are preparing a further paper which covers these wider issues as well as the specific urgent issue relating to conversions of unit trusts to PAIFs which is covered here.

Scotland

Neither the existing relief from SDLT for conversions of an authorised unit trust to an open-ended investment company (nor the rUK proposals described in the UK Government consultation) apply to LBTT on property located in Scotland and may therefore act as a disincentive to investment in Scottish property by funds if no similar reliefs and measures for LBTT are put in place. This could have a negative effect on general market sentiment, regarding the Scottish commercial property market.

The lack of such an LBTT relief and an appropriate LBTT regime may also act as a brake on establishing or expanding property authorised funds if such funds have to be limited to property situated outside Scotland. Several PAIFs, authorised property unit trusts and tax transparent funds are currently based in Scotland.

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General Considerations

LBTT (and SDLT) are property transaction taxes charged at a level considered by the respective governments to be appropriate to the commercial transfer of significant assets typically happening on an infrequent basis. They are controversial in that they may, for example, make the property market less liquid than it would otherwise be. Hence one reason why lower percentage rates are charged on smaller property transactions, as there might otherwise be a ‘freezing’ effect on house sales and on mobility for people. The Scottish Government has notably taken steps to prevent a cliff edge effect when there is a change in rate which causes distortions in prices around the levels where the rate if tax increases (a move which, we note, has subsequently been followed by the UK Government).

Property funds are a means of enabling a much wider range of investors to take (often quite small) interests in property while spreading risk and, on an international basis, investors can make decisions about spreading their investment between property, equities and debt funds as well as other types of asset. They are also widely held by pension funds and other institutional investors.

The UK as a whole hosts about 35% of the fund management business based in Europe and is the leading centre for fund management in Europe and second only to the United States worldwide. More than 10% of the UK fund management sector is currently based in Scotland and so the business is proportionately as (or more) economically important to Scotland than it is to the UK as a whole.

Proposal

We consider that the Scottish Government with Revenue Scotland should examine the existing relief from SDLT provided at SI 2008/710 and give urgent consideration to instituting a similar relief as regards LBTT as the lack of such a relief is already holding back the development of property investment funds in Scotland and investing in Scottish property.

If the Scottish Government is so minded then changes could be made by regulation using the enabling power in section 27(3) of the Land and Buildings Transaction Tax (Scotland) Act 2013.