



The Association of Real Estate Funds
65 Kingsway London WC2B 6TD
+44 (0)20 7269 4677
info@aref.org.uk

Mr J Swinney
Deputy First Minister
T4.23
The Scottish Parliament
Edinburgh
EH99 1SP

By email: John.Swinney.msp@scottish.parliament.uk

29 July 2015

Dear Mr Swinney

LBTT seeding relief for property authorised investment funds and LBTT treatment of co-ownership authorised contractual schemes

The Association of Real Estate Funds¹ is writing to explain the need for LBTT seeding relief for both property authorised investment funds (PAIFs) and co-ownership authorised contractual schemes (CoACSs) and to request a review of the LBTT treatment of CoACSs more widely.

The importance of property investment funds

Investment funds are an essential savings vehicle, particularly for smaller savers and investors that otherwise lack the scale necessary to access the capital markets. Property funds enable individuals to take often quite small interests in property while spreading risk. Property funds are also widely held by other types of investors including pension funds and other institutional investors.

A PAIF is a type of authorised fund designed for investors wishing to invest in property. In legal form it must be an open-ended investment company. 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.

A CoACS is a type of authorised contractual scheme (ACS). The assets are legally held by a depositary on behalf of the investors who are the beneficial owners. It has no legal personality in either Scotland or the rest of the UK.

The need for clarity of LBTT treatment and appropriate relief

A PAIF is a separate legal entity so owns property it acquires and is liable to LBTT on acquisition. AREF wrote to you on 1 May 2015 to express concern that there is no relief from LBTT when an existing authorised unit trust invested in property converts to a PAIF. Thank you for confirming that the Scottish Government will now consult on this. We look forward to responding to the consultation.

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.



If an existing property portfolio is transferred to a PAIF, the PAIF is liable to LBTT. This is a barrier to establishing new property funds when the transfer is typically effected in exchange for shares. The UK government confirmed, in Summer Budget 2015, its plan to introduce a seeding relief from stamp duty land tax (SDLT) in Finance Bill 2016. A lack of equivalent relief in Scotland will be a disincentive for new PAIFs to invest in Scottish property. Ideally relief would be available where several founder investors seeded a PAIF over a short period of time. This would encourage the formation of larger, more efficient, PAIFs. LBTT relief should also be available on properly structured PAIF mergers and reorganisations.

A CoACS has no legal personality. Each of the participants has a separate interest in property, proportionate to their investment in the CoACS. This means that not only are the participants liable to LBTT whenever a property is acquired, they are also liable to LBTT whenever one or the participants redeems units. Also, if units are issued or transferred to a participant, that participant is liable to LBTT. Calculating LBTT charges whenever units are issued, transferred or redeemed (which could happen many times a day) is highly impractical. As such it's unlikely to be desirable for a CoACS to hold property. The UK government has proposed solutions to these difficulties. Without the Scottish government doing the same, there will be a disincentive to invest in Scottish property or to set up CoACSs in Scotland.

You can find further detail in the Appendix.

We urge you to consider these matters promptly. A lack of clear application of and suitable relief from LBTT may deter funds from investing in Scottish property. The property market in Scotland, especially for commercial property which is commonly held by funds, is likely to be adversely affected.

I look forward to your response. In the meantime, please feel free to contact me if you need any further information.

Yours sincerely

A handwritten signature in black ink, appearing to read 'John Cartwright', with a long horizontal stroke extending to the right.

John Cartwright
Chief Executive
The Association of Real Estate Funds

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

Scotland

Application of land and buildings transaction tax to property investment funds

Introduction

This note considers some issues with property funds (collective investment schemes focussed on investing in interests in land and buildings referred to as 'property' in this note) and LBTT. Where relevant it makes comparisons with the application of stamp duty land tax (SDLT) in the rest of the UK (rUK).

Note: Our letter of 1 May 2015 covered an urgent LBTT issue which is preventing some existing property authorised unit trusts from converting to property authorised investment funds (PAIFs). This note considers wider issues for property funds regarding LBTT as well as the specific point of our previous letter.

Property funds may be either opaque for some or all tax purposes, such as:

- authorised unit trusts
- property authorised investment funds
- other unit trusts (sometimes domiciled in the Channel Islands – JPUTs and GPUTs)
- unauthorised unit trusts (normally exempt unauthorised unit trusts)

or transparent for most or all tax purposes, such as:

- partnership authorised contractual schemes (forms of Scottish or English limited partnerships)
- co-ownership authorised contractual schemes (contractual arrangements)
- other forms of partnership (or foreign partnerships recognised as partnerships in the UK)
- foreign contractual schemes recognised as transparent for all or most UK tax purposes.

A property fund 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 investment into property and for giving investors access to returns from holding property whilst spreading risk.

Issues for opaque property funds

An *opaque property fund* (or its trustee) is a legal person and so is capable of beneficially owning property. It is the person liable for any LBTT charge on its purchase of property in Scotland. Investors in such a fund do not need to consider LBTT on account of their investments as they hold shares or units in the fund and not interests in property.

However, there are issues when a fund is established using an existing property portfolio. The transfer to the fund of the property portfolio (seeding the fund) normally leads to an LBTT charge in respect of property situated in Scotland even where there is no economic change of ownership. This acts as a barrier to establishing new property funds.



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 an authorised unit trust to an OEIC. This covers, for example, conversion of an authorised unit trust to a PAIF. The relief is set out in United Kingdom SI 2008/710. No similar relief has been provided for in the case of LBTT. In addition, the UK government has consulted on extending relief for establishing PAIFs to property portfolios that originate from wider sources than existing authorised unit trusts and has confirmed its intention of legislating to achieve this objective.

If the application of LBTT to changes in fund structures is reviewed then it would be useful also to consider what happens, and whether this leads to economically appropriate results, in the case of fund mergers and other reconstructions (where there is no overall, fundamental or economic change of ownership).

Issues for tax transparent property funds

The issues for a *tax transparent property fund* are somewhat different. The property subject to the fund is held as a common tenancy under Scots law (or tenancy in common under England and Wales law) by the fund participants (unitholders) in proportion to their holdings of units.

Every issue of units or cancellation of units (both of which could be on a daily basis) results in a change of participants' interests in property and hence a charge to LBTT. Calculating and accounting for LBTT on every issue of units is impractical. Levying an LBTT charge on participants when one participant redeems units, marginally increasing the other participants fractional interests in property subject to the fund, is even more so.

In contrast, the transfer of a property portfolio to the fund by the owner in exchange for units does not result in any change of beneficial ownership. This means that seeding the fund (or transfers within a group of companies) can be undertaken without any LBTT charge arising.

Some similar issues have been identified with respect to SDLT for property situated in rUK. The UK government published a consultation document in July 2014 and announced its intention of taking steps to address the issues at Autumn Statement 2014, confirming this at Budget 2015 and Summer Budget 2015. The UK government response to the July 2014 consultation can be found [here](#). The UK government plans to hold further discussions to address the detail of the legislative approach.

UK government proposals and implications for Scottish property investment

Property authorised investment funds

A PAIF is exempt from corporation tax on its property investment business provided that it meets certain conditions. A PAIF distributes property income dividends (PIDs). These are treated as income arising from property in the hands of investors and are subject to deduction of income tax at the UK basic rate. (The Scottish rate of income tax does not apply to PIDs paid by PAIFs or UK-REITs).

A PAIF is the beneficial owner of property it holds and so pays SDLT/ LBTT on acquisition. On a disposal of property by a PAIF, the buyer is responsible for SDLT/ LBTT.

The UK government plans to introduce a seeding relief for PAIFs (chapter 3 of consultation document). This will allow an entity or group of entities to seed a newly established PAIF with an



existing property portfolio in exchange for units without an SDLT charge. The relief will remove (or at least reduce) an existing tax barrier to the establishment of new PAIFs. However, the proposal might be more effective if it permitted several founder investors to seed a PAIF over a short period. Although this would result in an exchange of economic interests between founder investors, the ultimate position of those investors would be economically the same as it was before the fund was seeded. This could encourage the formation of larger and more economically efficient PAIFs.

There are already methods acceptable to HMRC of achieving SDLT relief on properly structured PAIF mergers or reorganisations. In the case of a property authorised unit trust converting to a PAIF, SI 2008/710 applies. For mergers it should, in theory, be possible to apply the general mergers rules, although the regulatory structure applying to funds makes this commercially difficult. With the benefit of hindsight, it may have been better if the SDLT relief for conversion of an authorised unit trust to an OEIC had been drawn a little more widely to allow also for mergers and reconstructions.

We think that an LBTT relief, comparable to the SDLT relief, is required to continue to allow authorised unit trusts to convert to PAIFs. There is also the opportunity for Scotland to scope LBTT relief more widely. For example, relief would considerably simplify the commercial process in a merger of two PAIFs.

Co-ownership authorised contractual schemes

Authorised contractual schemes (ACSs) are arrangements for the common ownership and management of assets by a number of investors. An ACS may take one of two forms: a co-ownership fund (CoACS) or a partnership fund. The latter is taxed as a limited partnership. This note focusses on the former.

A CoACS is constituted by means of a contract between the fund manager, the depositary and the participants. It has no legal personality in either Scotland or rUK.

For the purposes of tax on income, participants are treated similarly to partners in a partnership and are taxable on their share of income which arises to the CoACS as a whole.

For capital gains tax (or corporation tax on chargeable gains) purposes, the assets within the fund are not treated as assets in the hands of the participants. Instead, the participants' assets are the units in the fund.

A CoACS was exempt from SDRT under FA 1999 Sch 19 but that charge has now been abolished.

The UK government anticipated significant interest in the ACS regime but had not anticipated that some of the earliest funds would concentrate on holding real estate and so did not immediately introduce provisions to cover this scenario.

In particular, there is no legislation to specify the position of a CoACS or of its participants as regards SDLT. HMRC has concluded that the participants, as common tenants (under Scots law) or tenants in common (under England and Wales law), have separate interests in property. It appears likely that this analysis will hold good for LBTT also. This will lead to considerable difficulties if a CoACS holds property and has many independent (non-grouped) investors as



there will be an SDLT and/ or LBTT charge (often both depending on the location and variety of property held) every time that a unit is issued, redeemed or changes hands.

The first property holding CoACS was set up by a Scottish financial institution, initially with only group companies as investors. As such group relief is due on any variation of interest between the investors, although this could be somewhat complex as we understand that Revenue Scotland is already aware.

Representations were made to the UK government and a consultation document was issued (linked above). The proposals (chapter 4 of the consultation document) suggest that:

- Transfers of beneficial ownership of rUK situate property by virtue of transfers of units in a CoACS will be exempt from SDLT.
- Where a CoACS purchases rUK property (or property is otherwise transferred to a CoACS) then the participants will be liable to SDLT. The fund manager will be required to settle the liability from fund assets on participants' behalf.
- SDLT will be charged when property is transferred to a CoACS by a participant even where there is no transfer of beneficial ownership (subject to any seeding relief).
- A seeding relief will enable an existing property portfolio to be transferred to a newly established CoACS without an SDLT charge (subject to anti-avoidance provisions).

General considerations

LBTT (and SDLT) are property transaction taxes charged at a level considered by the respective governments to be appropriate on transfers of assets which are typically infrequent. The taxes are controversial. For example, they make the property market less liquid. One reason for lower rates on smaller transactions is to minimise the risk of freezing house sales and restricting mobility of people. The Scottish government took steps to prevent a cliff edge effect around the levels where the rate of tax increases as this causes price distortion. The UK government subsequently followed this approach.

Property funds are a means of enabling a wide range of investors to take (often quite small) interests in property while spreading risk. Investors can spread their investments between property, equities, bonds and other types of asset, and may diversify internationally. Property funds are also widely held by pension funds and other institutional investors.

A lack of clear application of and suitable relief from LBTT may act as a disincentive to investment in Scottish property by PAIFs and CoACSs. This could have a negative effect on the Scottish property market. It may also act as a brake on establishing or expanding PAIFs and CoACSs if such funds limit property investment to property situated outside Scotland. Several PAIFs, the first property CoACS and several property authorised unit trusts are based in Scotland. If LBTT applies less favourably than SDLT, this may in future be less likely.

The UK as a whole hosts about 35% of Europe's fund management business. It is the leading fund management centre in Europe and is 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 as it is to the UK as a whole.



Proposal

We consider that the Scottish government with Revenue Scotland should examine the UK government's July 2014 consultation on the SDLT rules for property investment funds and the responses to that alongside the UK government's subsequent comments on their intentions in Autumn Statement 2014, Budget 2015 and Summer Budget 2015. We consider that the Scottish government with Revenue Scotland should then consider what LBTT treatment would be right for PAIFs and CoACSSs.