A Consultation on Land and Buildings Transaction Tax – Property Investment Trusts

Comments by the Scottish Property Federation – August 2018

Introduction

1. The Scottish Property Federation (SPF) is a voice for the real estate industry in Scotland. We include among our members: property investors, including major institutional pension and life funds; developers; landlords of commercial and residential property; and professional property consultants and advisers.
2. We are happy for the Scottish Government to publish this response and to share its contents with other public bodies.

Background

3. Scotland is a leading player in the investment and fund management sector, both within the UK and internationally. Over £620bn of assets (of which property is only a part) are managed in Scotland out of a UK-wide industry of £6.9trn[i]. Some 24% of the UK investment management industry is employed in Scotland, directly meaning over 7,500 people often in key investment management roles, which far outstrips any other part of the UK outside of London. Although a relatively smaller proportion of these assets are directly managed by Scottish-headquartered firms (9%)[ii], this is nonetheless a hugely significant figure. In short, fund management is a key part of the Scottish economy and we believe the Scottish Government should act to ensure it remains competitive as a location for this important industry.
4. The subject of this consultation is of course investment in real estate. While there is a growing element of residential investment in the markets, this remains largely commercial property driven. Commercial property investment represents one of the major sectors of investment management in the UK. In 2017 the Investment Association reported a total of some £160bn of equity commercial property investment by its industry across the UK[iii], a hugely important figure in the context of ongoing risk-adversity towards real estate (as well as risk regulation) from traditional investment bank lenders.
5. This consultation focuses on Property Authorised Investment Funds and Co-ownership Authorised Contractual Schemes from the perspective of Seeding Relief from LBTT. We support the introduction of a relief that will at least achieve parity with SDLT. We feel that it is important Scotland continues to take a lead in a competitive investment industry and avoids unnecessary disadvantages for the Scottish fund management industry. Indeed, this is an opportunity to improve upon certain disadvantages of the current UK seeding relief regime which are addressed in detail in our answers below.

Property Investment in Scotland and the UK

Question 1: Does this chapter provide an accurate picture of the Scottish property fund and investment landscape

6. Scotland has a strong investment and asset management sector evidenced by our introductory comments. Real estate is a significant part of this strength. While there are perhaps fewer large scale funds headquartered in Scotland following the merger and acquisition of several major names over the past 20-30 years, there are however many successful medium sized and (relatively) smaller fund businesses, particularly in Edinburgh. The benefit of these funds is that they encourage both investment in real estate and the retention and enhancement of value in the sector.

7. Value is hugely important for the support of the wider economy. The Bank of England estimates that for every 10% fall in commercial property values there is roughly a 1% fall in UK-economy wide investment.[iv]. This is partly because of the role of property values as collateral for businesses. This suggests that the importance of commercial property is much greater for the economy than its nominal sector size and this is one reason why the performance of commercial property values is keenly monitored by the Bank of England. Major investment in real estate is also important for the development and re-development of major assets in the built environment and this itself contributes greatly to the performance of the economy in Scotland. The Fraser of Allander Institute recently reported that for every £100m of demand for commercial property a further £73m was contributed to the wider economy.[v]

8. Chapter 2 correctly addresses the scale of commercial property investment transactions in Scotland during 2017. In 2018 the scale of investment transactions thus far appears to have been sustained.[vi]

Question 2: In terms of the size of property fund assets in Scotland, how many funds do you estimate hold Scottish assets, what is the total value of these funds and how large (%) is their exposure to Scottish property?

9. In 2015 research for SPF assessed some £46bn of commercial property by value in Scotland, of which £22bn was identified as investment stock[vii]. This is slightly less than the UK average, but it is nonetheless significant. In addition, the last 20 years have seen major changes in the property investment market. Aside from traditional asset classes of office, retail and industrial assets funds now invest in hotels, other leisure (cinema, pubs), student accommodation and now build to rent.

10. The level of exposure to Scottish real estate will vary from fund to fund. The IA annual survey found that some 41% of its funds invested in property[viii]. However, the Investment Property Databank traditionally identified Scottish assets as representing around 4% of a major investment portfolio. This may seem less than it ought to be, but it should be remembered that commercial property investment in the UK is hugely distorted by the vast value of the London market, which is estimated in July 2017 to account for over 51% of the total value of UK commercial property investment (IPF: Size & Structure of the UK Commercial property market)[ix]. Typically, a fund will hold around 5% of its real estate assets in Scotland. Ideally, we would wish to develop the depth of the Scottish real estate investment market with a view to raising average holdings of Scottish real estate by funds.

Seeding Relief

Question 3: Do you think that the Scottish Government should introduce a seeding relief for PAIFs and CoACS?

11. Yes - in order to stimulate property investment funds and to support the Scottish fund investment and management sector. Our colleagues at the British Property Federation in relation to seeking reform of the current SDLT Seeding Relief (applying to PAIFs and Co-ACSs) have argued the need for an effective Seeding Relief is particularly important for the purposes of life insurance funds. It is argued that these funds are in need of a seeding relief because regulatory and structural changes affecting the retention of real estate assets in these funds' portfolios means that an incentive is necessary to create a more favourable environment for life insurance funds to invest in real estate - hence the requirement for an effective and supportive seeding relief from LBTT.

Question 4: Please briefly describe any positive impacts that would accompany LBTT parity with SDLT for a seeding relief?

12. We will argue that any Scottish seeding relief system should be more effective than that introduced for SDLT to date. The positive impact would be to encourage the identification of Scottish real estate assets for PAIFs and CoACS. It would also avoid the negative consequence of Scottish real estate assets being viewed as a tax and regulatory burden and thus cut off from potential fund interest.

Question 5: With regards to a seeding relief - how would a 'do nothing' approach on the part of the Scottish Government affect your business and future business decisions?

13. Major funds among our membership report that if a negative relationship continues whereby Scottish assets within a fund are not granted seeding relief status, then they could inevitably come to consider carving out Scottish assets from wider fund investment activity. This could undermine the value of these assets as they become relatively less attractive to potential new investment funds and this could have a negative impact on the economy for the reasons explained in Chapter One.

Question 6: If the Scottish Government were to proceed with a LBTT seeding relief, are there any aspects of the SDLT arrangements which you believe should be changed if replicated for LBTT purposes.

14. Our colleagues and members with the British Property Federation have reported that the reason for the relatively low take-up of seeding relief opportunities thus far with SDLT is the 'clawback mechanism' introduced by the UK Government. We understand this is potentially under current consideration within the UK Government. The clawback arrangement has clearly been a significant hindrance to development of funds transferring into Co-ACSs arrangements, particularly from the life insurance sector which still accounts for just under a third of total UK fund management value. One key reason for the clawback mechanism being a deterrent is the risk it adds to the life insurance fund of losing the seeding relief for a transferred fund. This is because ultimately it will be the decision of the policyholders as to whether to retain a certain number and value of assets within the fund – if this falls below the given thresholds then the relief could be withdrawn with little or no ability of the fund manager to intervene.

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LBTT Treatment of Co-owned Authorised Schemes

Question 7: Do you agree that the Scottish Government should introduce parity with SDLT by providing a relief for the exchange of CoACS units?

15. It may be possible to replicate the broad structure of the SDLT relief for Co-ACS but the clawback provisions should not be transposed into LBTT. There is already a General Anti-Avoidance Rule in place under Scottish tax management legislation and this should be utilised for the purpose of protecting CoACS LBTT relief from any perceived tax avoidance concerns (see our comments in answer to Questions 11-18 below).

Question 8: Please briefly describe any positive and negative impacts that would accompany such a relief?

16. Co-ACS were introduced by the UK in 2013 and have the benefit of matching investors' tax liabilities with their proportional size of units within a Co-ACS. The intention of a relief for CoACS would be to provide an incentive for the creation of new property investment funds that would include Scottish real estate. This would make investment in Scottish real estate relatively more attractive and open to new forms of investment. In turn this will sustain and enhance the value for the sector which will make it relatively more attractive, thus supporting business investment and the wider economy.

Question 9: With regards to a CoACS relief - how would a 'do nothing' approach on the part of the Scottish Government affect your business and future business decisions?

17. Although the establishment of a relief for CoACS has had a slow start under SDLT this could readily be rectified by the UK authorities. In that case Scottish property would become less attractive to new (transferred) funds forming CoACS and could be said to be put at a competitive disadvantage. This would not simply be the tax per se but the regulatory and management consequences whenever CoACS units were redeemed or subscribed to.

18. We fear the likely outcome would be therefore that investment funds would still convert to CoACS but would carve out their Scottish assets and, once established, would continue to avoid investing in Scottish assets because of their different tax treatment.

Question 10: Do you have any other comments not covered by the previous questions around providing a relief for the exchange of CoACS units?

19. No further comments. We support a relief being introduced for CoACS units in order to avoid Scottish real estate being put at a competitive disadvantage compared to the wider UK fund industry.

Tax avoidance

Question 11: Please identify and describe any impacts on UK taxes (non-SDLT) that could occur following the proposed amendment to LBTT.

20. Many investors, including collective investors are tax exempt persons and this tax efficient amendment will enable such investors to combine with tax payers who will themselves be subject to tax on an individual basis. Therefore we see little if any tax negative outcomes from the proposed amendment.

Question 12: Can you identify any potential unintended impacts or effects on the current LBTT regime through providing a parity with SDLT on the treatment of CoACS or through providing a seeding relief for PAIFs and CoACS?

21. Only if the Scottish Government were to transpose directly the SDLT provisions including the clawback mechanism. In this event, the unintended outcome might be to make the relief uncompetitive should the UK reverse or significantly amend its own clawback provisions.

Questions 13: If the Scottish Government introduced a relief, do you believe it should introduce GDO rules for CoACS or do you believe another test should be equally as effective in combining tax avoidance.

22. We believe the UK tests are appropriate and from the viewpoint of large funds this would be helpful in retaining consistent criteria with the wider UK portfolios.

Question 14: If the Scottish Government introduced the proposed reliefs, should it introduce general portfolio tests with the same thresholds as the UK (based on the value of pan-UK property) or should a more Scottish oriented threshold/measure be used?

23. Yes -a general portfolio test for commercial property to maintain parity for UK wide investment vehicles. We feel there is a case for a much smaller residential threshold for the number and value of assets however. We would be willing to engage with the Scottish Government to identify an appropriate portfolio test for Scottish residential property.

Question 15: If the Scottish Government introduced the proposed reliefs, should it legislate for a percentage of ownership test in the same manner as the rest of the UK?

24. Yes.

Question 16: Should the Scottish Government, if introducing the proposed reliefs, implement the same clawback provisions as introduced under the UK's SDLT regime? If not, what conditions should be applied and how would you suggest recovery of the tax should operate?

25. This should be undertaken through the GAAR mechanisms for Revenue Scotland. The clawback provisions are too draconian under the UK tests and this one of the main reasons why take-up of the relief has not met expectations in the UK, resulting in less new investment than might otherwise have taken place.

Question 17: Do you believe that the fund managers and scheme operators should be liable for the recovery of any tax liability resulting from these potential reliefs?

26. Only within the terms of their mandates.

Question 18: Please identify and describe any other areas of potential tax avoidance that you think could arise by amending LBTT legislation to provide a seeding relief and change LBTT treatment of CoACS?

27. No comments.

Question 19: If seeding relief was introduced in Scotland, should it just apply to non-residential property?

28. No, for the reasons explained under Question 1, the real estate investment sector continues to expand into new asset classes and we would not wish to cut off these forms of investment.

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Effect on Equal Opportunities, Human Rights, Island Communities, Local Government, Sustainable Development

Question 20: Would LBTT parity with SDLT regarding PAIFs and CoACSs, in any way, impact upon equal opportunities, human rights, island communities, privacy and/or sustainable development in Scotland?

29. No – we do not believe so.

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[i] Asset Management in the UK 2016-17, The Investment Association Annual Survey, September 2017
[ii] Ibid
[iii] Ibid
[iv] Bank of England Financial Stability Report, June 2018
[v] The economic contribution of the commercial property sector, Fraser of Allander Institute, March 2018 for the Scottish Property Federation
[vi] SPF Commercial Sales data Jan-Mar 2018, including Co-Star investment transactions update
[vii] Commercial real estate and the Scottish economy, Colin Jones and Edward Trevillion, Heriot-Watt University for SPF, June 2015
[viii] Asset Management in the UK 2016-17, The Investment Association Annual Survey, September 2017
[ix] The size and structure of the UK commercial property market, July 2017 Update, Investment Property Forum