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Property REITs

A more positive Budget announcement was that a new type of property investment is to be introduced in January 2007 – REITs (pronounced ‘REETs’), which stands for Real Estate Investment Trusts.

Reits are common in other countries such as Australia, the US and Japan, and are designed to encourage property investment in return for tax advantages. Income and capital gains made within the UK REIT will be exempt from corporation tax, provided that 90% of the income is distributed to investors, when it will be subject to income tax in their hands.

This places REITs on a level with Unit Trusts and OEICs (Unit Trusts’ pan-European counterpart). These suffer little or no tax on their income and are exempt from tax on their capital gains. Again, it is the investors who are charged to tax, in the same way as if they held individual securities directly.

It has also been confirmed that, like Unit Trusts and OEICs, REITs will be eligible for ISA investment. In this respect REITs will have an advantage, because investors’ income will be tax-free, whereas property income from ISAs which invest via Unit Trusts and OEICs is treated in the same as dividend income and is reduced by a non-reclaimable tax credit.

One feature of Investment Trusts (including REITs), which makes them riskier than Unit Trusts and OEICs, is that Investment Trusts can borrow funds to invest; and one of the conditions for the tax benefits of REITs is that income must cover the interest payments by a factor of 1.25.

Another condition is that full tax benefits are only available if no single shareholder holds more than 10% of the shares in a REIT. This may discourage smaller companies from becoming REITs unless further concessions are introduced. However, many of the large property companies have indicated their intention to do so.

Of course, no one should invest for tax reasons alone, and senior industry figures are warning that the UK property market is currently overvalued and investors would be wise to steer clear for the time being. Valuations in some overseas property markets appear to be less stretched.

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