

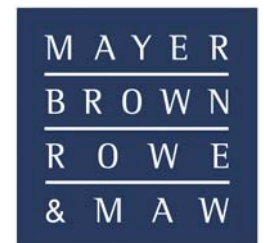


To REIT or not to REIT...

Sandy Bhogal

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Corporate Tax Group, London



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Introduction

- This presentation provides:
 - an overview of alternative property investment vehicles used in the UK:
 - UK Limited Partnerships
 - UK and offshore unit trusts
 - Luxembourg holding companies
 - Offshore haven SPVs
 - Property Derivatives
 - and a detailed look at:
 - the newly introduced UK-REIT regime
 - the advantages and disadvantages of the UK-REIT regime

Introduction - 2

- Other tax considerations in property investment are also considered:
 - Stamp Duty Land Tax
 - VAT
 - UK disclosure regime
 - UK anti-avoidance legislation

Principal Property Investment Vehicles for the UK

- UK Limited Partnerships
 - Certain partners elect not to take active role in operation of the limited partnership in exchange for limited liability
 - Liability is limited to the amount of their capital contribution – these are typically small and topped up with interest free loans
 - Tax transparent for UK income and capital gains purposes i.e. profits and losses arising from partnership business are treated as accruing directly to partners by reference to their partnership share
 - Profits can be shared between investors in various ways
 - Not suitable where new investors are to be admitted or investors change hands as there will be a Stamp Duty Land Tax (“**SDLT**”) cost in such circumstances
 - Non-UK limited partners resident in a territory with which the UK has a double tax convention similar to the OECD Model Convention and who hold their interest in the limited partnership as an investment will not be treated as partners in an enterprise which carries on business in the UK through a permanent establishment merely because of their participation in the limited partnership
 - SDLT is payable on transfer of partnership interests (even where documented as retirement and accession)

Principal Property Investment Vehicles

■ Unit Trusts

- An open-ended pool of investments constituted by a trust deed
- See-through entities which must pass all income and gains through to the unit holders
- Net income is taxed directly on the unit holders
- Exempt from capital gains tax on the sale of UK property
- Units can be traded without a stamp duty charge
- New investors may be introduced without triggering capital gains disposals for existing investors
- Seeding relief for SDLT abolished by Finance Act 2006. This gave relief from SDLT when property was transferred into a newly formed unit trust



Principal Property Investment Vehicles

- Luxembourg holding companies
 - A société de participation financière (SOPARFI) is used as a holding company for onshore and offshore SPVs which hold UK property
 - The SOPARFI is subject to corporate income tax in Luxembourg (at the rate of 29.85% from 1 January 2007)
 - However, the participation exemption applies if, generally, the SOPARFI has a shareholding of at least 10% in another Luxembourg company, a company residing in an EU member state or any fully taxable corporation, which it holds for at least 12 months
 - Dividends and capital gains on the disposal of shares are exempt if the exemption applies
 - Luxembourg's wide treaty network protects against local taxation
 - The SOPARFI will require sufficient "presence" for it to qualify as a treaty resident of Luxembourg
 - Dividends paid by the SOPARFI are generally subject to a 15% withholding tax. However, this can be avoided if the SOPARFI is financed with debt or hybrid instruments instead of equity



Principal Property Investment Vehicles

- Offshore haven SPVs
 - These are often incorporated in jurisdictions such as Jersey, Guernsey and the Cayman Islands and are used to hold UK property
 - It is possible to obtain tax-exempt status in these haven jurisdictions for payment of a nominal fee (e.g. £600 payable annually in Guernsey). Some of these jurisdictions are moving to a 0% corporate income tax regime
 - Tax exempt status exempts the SPVs from tax on foreign income
 - The SPVs can make dividend and interest payments to non-residents without withholding tax
 - The offshore haven SPV will only be liable to UK corporation tax if it is trading in the UK through a 'permanent establishment' situated in the UK



Principal Property Investment Vehicles

- Activities of offshore haven SPVs are likely to constitute investment rather than trading
- Where the SPVs are not trading, UK property income of the SPV is taxed by HMRC through the tenant (or a UK letting agent should that be the case) withholding tax at 22% on property income and accounting for this to HMRC
- A non-resident landlord such as the offshore SPV can apply to receive its rents gross under the Non-Resident Landlords Scheme, provided it obtains approval from HMRC
- Approval is usually granted within 6-8 weeks of the application
- Expenses, loan interest and tax depreciation can be deducted from rental income so that only net amounts are taxed

Property Derivatives

- A growing market
- Property derivatives have the Investment Property Databank All Property Index (the IPD Index) as their underlying asset rather than actual properties
- IPD Index covers 75% of retail, office, commercial and industrial properties in the UK market
- Investors can create a synthetic property portfolio without having to invest or trade in actual properties
- What constitutes a derivative for tax purposes will follow the accounting treatment under UK GAAP or IAS
- No SDLT is currently payable on property derivatives



Property Derivatives (cont.)

- Gains and losses on property derivatives are treated as chargeable gains and allowable losses
- Investors can therefore offset losses from property derivatives against gains in other parts of their portfolio from non-property assets
- In cases where the derivatives are part of a trade, they gains and losses are taxed on income rather than capital account.
- In cases where the derivative is a hybrid of a property and non-property derivative, the gains and losses are allocated between income account and capital account
- Impact of IFRS on property derivative transactions

REITs – Introduction

- **What are REITs?**
 - A new form of collective investment in property with various tax benefits
 - Unlike conventional property investment companies, REITs pay little or no tax at the company level provided most of their earnings are paid out to shareholders as dividends
 - The REITs regime is governed by FA 2006 (and various supporting regulations) and came into force in the UK on 1 January 2007

- **Why?**
 - Shares in listed property companies trading at below net asset value
 - Increasing concerns about the prevalent inefficiencies in the UK real estate sector driven largely by soaring debt levels and poor liquidity
 - Individual investors are finding it increasingly difficult to invest in real estate either directly or indirectly through conventional means
 - Historical evidence suggests that REITs will regenerate the property market and ensure liquidity and efficiency

REITs – Introduction (cont.)

▪ Who can be a REIT?

Any company carrying on a “property rental business” satisfying:

- six conditions relating to the company;
- six conditions relating to its business, more commonly broken down as:
 - three conditions relating to its tax exempt business;
 - three conditions referred to as “balance of business” conditions;
- a condition relating to the shareholding of the company; and
- a condition relating to the terms under which it borrows money

REITs – Introduction (cont.)

- **How does a company convert to REIT status?**
 - Obtaining REIT status is an elective mechanism, i.e. a company seeking to convert to REIT status should give notice to HMRC of its intention
 - An entry charge of 2% of the market value of the properties (to be used within the company's property rental business) is also payable
- **What happens when a company comes within the REIT regime?**
 - Once the company has entered the regime, a line is drawn between the property rental activities of the company (“exempt activities”) and other activities (“residual activities”)
 - Different tax treatments apply to the two businesses carried on by the REIT
 - Income and gains arising within the ring fence (i.e the exempt business) are exempt at the company level and taxed in the hands of the investors
 - Income and gains arising outside the ring fence (i.e. the residual business) are treated in the normal manner and are subject to UK corporation tax

REITs – Introduction (cont.)

- **The end result?**

- From the investor's perspective, the property rental business of the REIT is tax exempt
- The economic effect is as if the investor held the property directly and not through the REIT

REITs – The Conditions

- Six conditions relating to the company
 - The company should be UK-resident for tax purposes and not be resident elsewhere
 - The company should not be an open-ended investment company (“**OEIC**”)
 - The shares of the company should be listed on a “recognised stock exchange”
 - The company should not be a “close” company
 - The company may only have two classes of shares in issue at any given time
 - The company can only enter into normal commercial loans

Company Condition 1 – Tax Residence

- Company should be resident in the UK and not resident in another state for tax purposes
- “Company” includes bodies such as industrial and provident and friendly societies, although other conditions of the regime will preclude them from entering the REIT regime
- Dual resident companies (i.e. companies deemed to be tax-resident in two countries under their respective tax laws) would not meet this condition unless:
 - there is a Double Taxation Agreement (“**DTA**”) in place between the UK and the other state;
 - the DTA has a tie-break clause; and
 - the operation of the tie-break clause allocates residence to the UK

Company Condition 2 – Closed-ended

- The company should not be an open-ended investment company (“**OEIC**”)
- For the purposes of the REIT legislation, OEICs includes any vehicle with variable capital set up within or outside the UK
- Company conditions 1 & 2 should be met before the company can give notice to enter the REIT regime

Company Condition 3 – Shares Listing

- The company is required to be listed on a recognised stock exchange
- A list of “recognised stock exchanges” for REIT purposes is at:
www.hmrc.gov.uk/fid/rse.htm
- This condition need not be fulfilled at the time an election application is made, although it must be met once the application has been approved and the company is within the REIT regime

Company Condition 4 – Not a Close Company

- The company must not be “close”
- “Close” companies under UK tax legislation are those that are controlled by five or fewer participants
- However:
 - companies which are close only as a result of having a participant who is a limited partnership that is a collective investment scheme can meet this condition;
 - but, not companies which are owned (more than 65%) by a listed company (UK-REITs cannot be subsidiaries of a listed company but can themselves have subsidiaries)

Company Condition 5 – Classes of Shares

- A company may only have two classes of shares in issue at any given time
- The two classes that a company may issue are:
 - ordinary share capital; and
 - non-voting fixed rate preference shares
- The company is not allowed to issue more than one class of ordinary share capital

Company Condition 6 – Prohibited types of loan

- Company Condition 6 imposes certain restrictions on the manner in which the company can borrow money
- The company cannot borrow:
 - on terms that entitle the lender to interest which depends on the result of the company's business; or
 - the value of the company's assets; or
 - in excess of market rates; or
 - on terms which entitle the recipient to receive an excessive return on repayment i.e. a legislative catch-all provision
- However, a UK-REIT can issue convertible debt provided that:
 - conversion is into a single class of ordinary share; or
 - into fixed rate non-voting preference shares that the company is permitted to issue under Company Condition 5

Tax Exempt Business Condition 1 - Three or more properties

- The company's property rental business should involve at least three separate rental properties (a shopping centre can be multiple properties)
- The three property requirement must be met throughout each accounting period
- Failure to meet this condition does **not** result in automatic expulsion from the regime provided:
 - the breach is minor;
 - does not last for too long; and
 - has not happened too often
- HMRC has not specified in their guidance what exactly this means



Tax Exempt Business Condition 2 – Property Value

- The value of any one property involved in the property rental business cannot be more than 40% of the value of all the property assets in that business
- This condition applies throughout each accounting period
- Failure to meet it does not always result in immediate removal from the regime
- If the breach is minor and the condition is not breached repeatedly, the company may remain in the regime

Tax Exempt Business Condition 3 – Owner Occupation

- The property rental business of the company must not involve property that is:
 - owner-occupied; or
 - occupied by another company which is controlled by the REIT; or
 - occupied by another company whose shares are stapled to the shares of the REIT
- An example of this would be a property used by the UK-REIT for its own business

The Distribution Condition

- The company is required to distribute at least 90% of the profits of its tax-exempt business
- In some circumstances, the company may distribute less than 90% of the tax-exempt profits and remain in the regime. These fall into three categories:
 - there are legal impediments to distribution;
 - if the finally agreed measure of tax-exempt profits is higher than the amount returned; and
 - if sufficient distributions are declared but not paid out to certain shareholders as a result of reasonable steps taken in connection with the 10% rule.
- Failure to meet the 90% distribution requirement will result in an additional tax charge on the company unless a distribution is made within 3 months of the profits for a period becoming final which fulfils this condition



Balance of Business Condition 1 – Income Test

- At least 75% of the "total profits" of the company (group in the case of a Group REIT) must be derived from its property rental business
- **"Total profits"** relate to both the profits of the tax-exempt business and the non tax-exempt business
- **"Profits"** (i.e. income) are usually measured under international accounting standards ("**IAS**"), before the deduction of tax and excluding realised and unrealised gains or losses on property
- The accountancy-based measure of income of the tax-exempt business used for this test is unlikely to be the same as the measure of income used for the 90% Distribution requirement (which is a measure of income for tax purposes)



Balance of Business Condition 2 – Asset Test

- At least 75% of the assets of the company must be involved in the tax-exempt business on the first day of the accounting period
- Where a company is unable to meet this condition, it can still remain within the REIT regime provided it can meet this condition before the last day of the first accounting period
- The catch, however, is that an additional amount of tax will be charged to such companies. This will be 2% of the growth of the investment property from the date of entry to the regime to the end of its first accounting period
- The valuation is based on IAS or on a fair value basis if there is a choice of methods
- Although any sums of cash awaiting investment can count as an asset of the property rental business for the second Balance of Business Condition for two years, interest or other income arising on the cash does not form part of the income of the property rental business



The Substantial Shareholder Condition

- A UK-REIT may be hit with an additional tax charge if it pays dividends to an investor with more than 10% interest in the company or its dividends
- However, no tax charges or consequences will arise if the REIT can demonstrate that it has taken reasonable steps to prevent paying a dividend to a substantial shareholder
- Some of the steps taken by the REIT that HMRC will accept as being reasonable for the purposes of this condition are:
 - putting in place a mechanism that can identify holders of excessive rights in the company; or
 - a prohibition on the payment of dividends on shares that form part of the shareholding of a substantial shareholder unless certain conditions are met; or
 - a mechanism to allow dividends to be paid on shares that form part of the shareholding of a substantial shareholder where the shareholder has disposed of his right to dividends on his shares; or
 - a mechanism that is designed to prevent a substantial shareholder from being beneficially entitled to dividends on his shareholding

The Interest Cover Condition

- A REIT will be able to borrow without incurring tax charges, provided that it complies with an interest cover test for property rental business which is set at 1.25 times taxable income before capital allowances and financing costs
- A breach of this condition does **not** result in an exclusion from the regime although a tax charge at 30% will be levied on the amount by which the financing costs exceed the amount of those costs, which would cause the ratio to equal 1.25
- Such excess financing costs will effectively be treated as income arising from the company's residual business
- It is not possible to set off any losses or reliefs against the tax charge
- A REIT may issue debt instruments which are convertible to ordinary share capital



REIT – Entry Charge

- In addition to meeting the conditions, a company converting into a REIT is also required to pay an entry charge in order to cover any revenue loss to HMRC arising from this new regime
- This entry charge will be 2% of the market value of the properties to be used within the company's property rental business
- The entry charge is payable at the same time as the corporation tax is payable on the profits of the first accounting period of the company after it has joined the regime
- Companies can also elect to spread the entry charge payment over a period of four years in instalments as follows (in such a case, the total entry charge will amount to 2.19%):
 - 0.50 per cent for the first instalment,
 - 0.53 per cent for the second,
 - 0.56 per cent for the third, and
 - 0.60 per cent for the final instalment
- If an asset that is initially treated as part of the tax exempt business is subsequently transferred to the residual business, a proportion of the entry charge will be refunded



REITs Taxation – Company Level

- Corporation Tax
 - A new accounting period commences on the first day the company comes within the purview of the regime
 - Any income arising from the ring fenced business is outside the scope of UK corporation tax
 - Any income or gains arising from the residual business outside the ring fence (say trading activities or property development activities) is subject to corporation tax at the standard rate of 30%

- Capital Gains
 - Companies' pre-entry assets are treated as being disposed of by the company and reacquired by the new REIT at market value
 - Any gain arising from this disposal is not chargeable

REITs Taxation – Company Level (cont.)

- Capital Allowances

- For capital allowance purposes, however, the transfer takes place at tax written-down value such that no balancing charges or allowances arise to the company
- The effect of this is that the tax-exempt part of the company's business takes over the capital allowance position of the company's property rental business
- Going forward, capital allowances cannot be claimed by the tax-exempt business or shareholder

REITs Taxation – Investor Level

- A UK REIT is obliged to distribute at least 90% of the profits arising from its tax exempt business by way of dividend
- From the investor's perspective, such distributions are effectively treated as UK property income arising from the direct holding of property
- Individual investors are therefore taxed on these distributions at their marginal income tax rates
- The legislation requires that distribution of profits from the ring fenced business is paid after withholding tax at the basic rate at 22% unless the recipient belongs to one of a number of specified categories of UK resident investors entitled to gross payment of distributions
- Charities, UK resident companies, foreign companies with permanent establishments in the UK, UK pension funds, local authorities and health service bodies and departments of the Crown fall within this list of UK resident investors entitled to gross payment of distributions
- Impact on investors (refer to the next slide)



Impact on Investors - 1

- 'A' is a UK-resident company involved in property investment

	'A' invests in a UK-REIT	'A' invests in a company which is a UK property holding company
Profit	100	100
UK Tax	0	30
Distribution	100	70
UK Tax on Shareholder	30	0*
Net Return	70	70

* there is no corporation tax on the receipt of UK dividends by a UK company



Impact on Investors - 2

- 'A' is a non-UK Pension Fund tax exempt in local jurisdiction

	'A' invests in a UK-REIT	'A' invests in a company which is a UK property holding company
Profit	100	100
UK Tax	0	30
Distribution	100	70
UK Tax on Shareholder <i>(assuming treaty relief provides for no withholding tax)</i>	0	0
Net Return	100	70



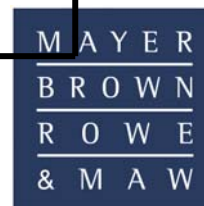
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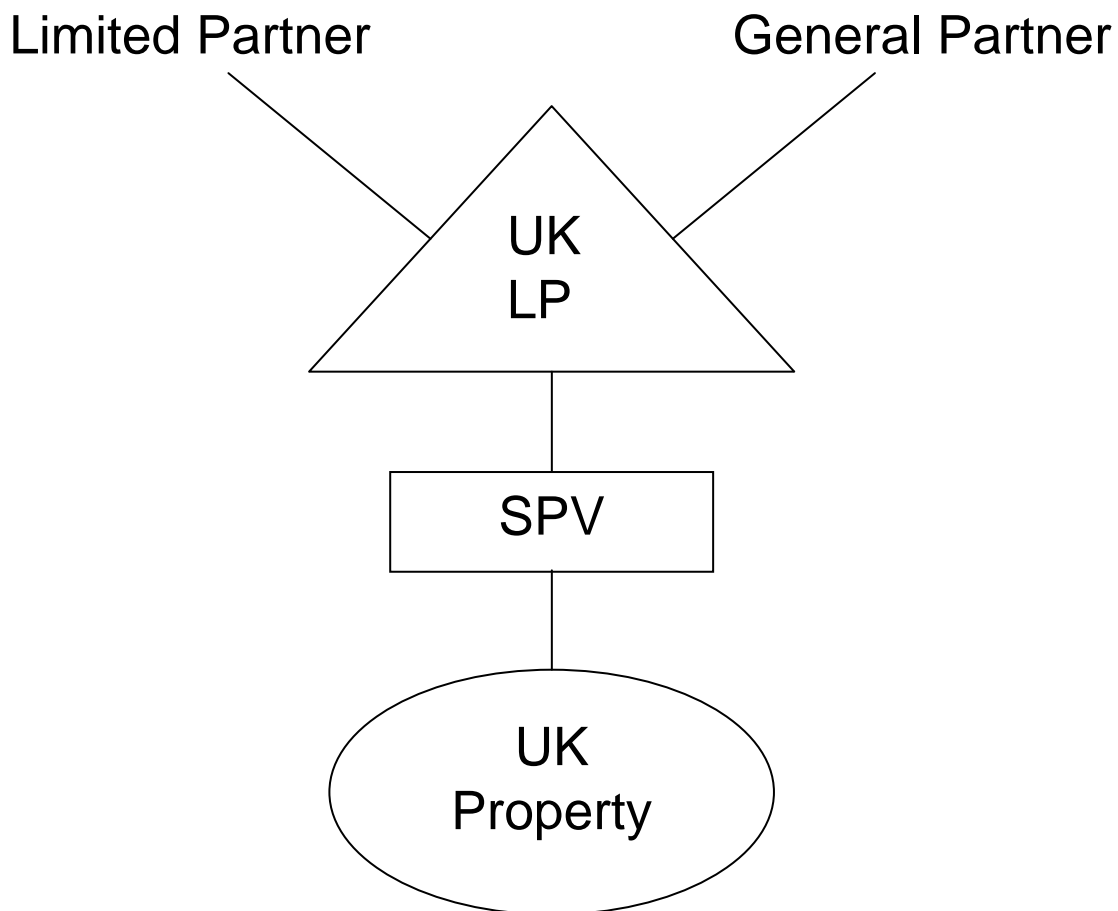
Impact on Investors - 3

- 'A' is an Overseas Shareholder resident in a jurisdiction with which UK has no Double Taxation Treaty (e.g. Isle of Man)

	'A' invests in a UK-REIT	'A' invests in a company which is a UK property holding company
Profit	100	100
UK Tax	0	30
Distribution	100	70
UK Tax on Shareholder	22	0
Net Return	78	70



Impact on Investors – REITs v. Limited Partnerships



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Impact on Investors – REITs v. Limited Partnerships

	UK SPV	Non-UK SPV	REIT
Profit	100	100	100
Tax	30	22	0
Distribution	70	78	100
UK Tax on REIT shareholder/limited partner	0	0	0/22*
Net Return	70	78	100/78

* depends on treaty relief



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Group REITs

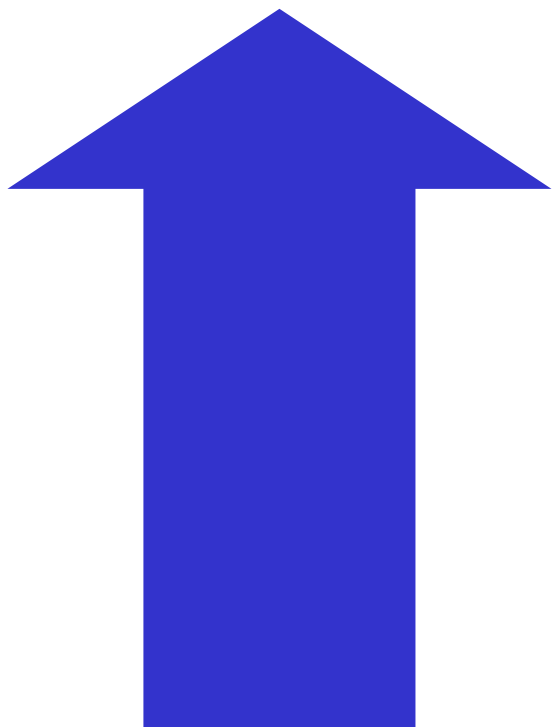
- A group of companies will qualify for REIT status if:
 - the principal company satisfies the “Company Conditions”; and
 - the group satisfies the “Business Conditions”
- A group comprises the principal company and its 75% subsidiaries together with their 75% subsidiaries provided that each subsidiary is a 51% subsidiary of the principal company
- For tax purposes, there are two groups: one carrying on the tax exempt property rental business and the other carrying on the residual business
- A non-UK company may be a member of a group REIT but it cannot be the group’s principal company
- Principal company must submit prescribed financial statements to HM Revenue & Customs

Joint Ventures

- Regulations provide for joint ventures to be included in a group REIT provided that:
 - the REIT has a 40% interest in the joint venture limited company; and
 - the joint venture company carries on a property rental business and satisfies the 75% assets/income balance of business tests.
- Where a JV company meets the necessary conditions, it can give a 'look-through' notice in respect of that company to ensure that the JV company is treated in much the same way as a 75%/effective 51% subsidiary of the group
- The effect of the notice is that assets, profits etc. of the JV company are taken into account in testing if the REIT meets the conditions of the regime

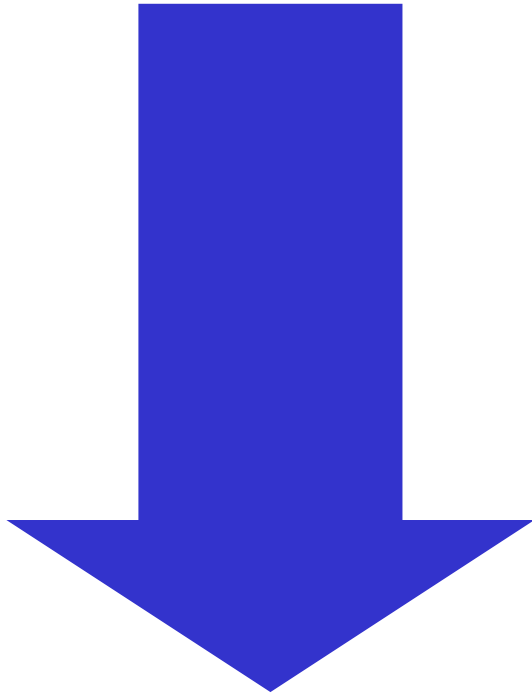


UK REITs - Advantages



- Extensive UK tax treaty network means treaty benefits (such as reduced or no WHT) are available to investors
- Provides an excellent investment option to tax-exempt investors in whichever jurisdiction (as long as treaty relief is available)
- Base cost uplift of properties within the ring fence
- Risk-adjusted returns more attractive than bonds, less risky than equity

UK REITS - Disadvantages



- Increased administrative and compliance burden and costs
- Expensive to set up
- Shareholding and distribution restrictions could be a hindrance to certain companies
- No specific SDLT regime for REITs

Market Impact of REITs

- Increased liquidity in the real estate sector driven by increased investment from greater number of investors
- Increased efficiency in the use of commercial property
- Reduction in the increased levels of debt-financing prevalent in the sector
- Removal of tax impact on share valuations means discounts to NAV will reduce substantially providing greater returns for investors
- Individual investors enter the property holding market

Stamp Duty Land Tax

- Introduced on 1 December 2003 to replace stamp duty on land
- SDLT is a tax on “land transactions” and arises irrespective of the nature and effect of any document
- SDLT is chargeable on the acquisition of:
 - an estate, interest, right or power in or over land in the UK; or
 - the benefit of an obligation, restriction or condition affecting the value of any such estate, interest, right or power
- The charge is drafted widely and includes the purchase of land and buildings, the entry into a lease of land or buildings and the transfer of a partnership interest that holds land or buildings
- Slab system of taxation i.e. entire consideration is charged at the applicable rate



Stamp Duty Land Tax (cont.)

- Usually 4% (depending on the amount paid for the property)
- Larger nil-rate band for residential property
- Special rules for calculating SDLT on leases
- New regulations introduced in December 2006 brought in new anti-avoidance rules with the result that:
 - previously used SDLT mitigation schemes or structures are no longer available;
 - complex planning which does not have tax avoidance as its motive may be inadvertently caught by the wide wording

VAT Implications

- Value added tax (VAT) is a sales tax levied on the sale of goods and services
- In some countries, including Australia, New Zealand and Canada, this tax is known as 'goods and services tax' or GST although different tax treatments may apply to ostensibly similar transactions in different jurisdictions
- VAT is an indirect tax, i.e. the tax is collected from someone other than the person who actually bears the cost of the tax
- Businesses (not individuals) can recover the VAT incurred as long as they make onward VATable supplies
- Thus the total tax levied at each stage in the economic chain of supply is a fraction of the value added by a business to its products
- Grant of any interest in or right over land is generally an exempt supply (i.e. no VAT is chargeable)
 - Some supplies of land are standard-rated (17.5%) e.g. grant of the freehold interest in a new commercial building
 - Others are zero-rated

VAT Implications (cont.)

- It is possible to 'opt to tax' supplies that would otherwise fall to be treated as exempt
- The effect of this is that VAT will be chargeable on most supplies of opted land
- *Why would a business choose to charge VAT on an exempt supply?*
 - The reason is VAT recoverability, i.e. VAT incurred in relation to making taxable supplies is recoverable, whereas that which is incurred in relation to making exempt supplies is not
 - Generally businesses will opt to tax either to recover VAT incurred on professional fees in relation to the sale of the property or if there are substantial maintenance expenses involved
- Once an option has been made it cannot be revoked for 20 years, with the exception of a three-month 'cooling off' period (provided no VATable supply has been made of the land or input VAT recovered in relation to it during the three months)

Disclosure and Anti-Avoidance Regimes – Direct Tax

- Introduced by Finance Act 2004
- Relevant initially to income tax, corporation tax and capital gains tax
- The objectives of the regime are to obtain:
 - early information about tax arrangements and how they work; and
 - information about how they used them
- “Promoters” of certain tax avoidance schemes are required to disclose those schemes to HMRC
- Allows HMRC to close loopholes in the legislation previously exploited by taxpayers

Disclosure and Anti-Avoidance Regimes - SDLT

- Finance Act 2004 regime subsequently extended to Stamp Duty Land Tax
- “Promoter” must report avoidance scheme to HMRC
- Disclosure is required where:
 1. an SDLT advantage might be expected to be a main benefit;
 2. the scheme does not relate solely to residential property;
 3. the market value of the land is £5m or more (or this is not known); and
 4. none of the exceptions from disclosure apply.
- Penalties for failure to disclose

Disclosure and Anti-Avoidance Regimes - VAT

- A disclosure regime was also introduced on 1 August 2004 in relation to arrangements that are intended to give any person a VAT advantage
- The main obligation for disclosure rests with those taxable persons who are party to the scheme
- Disclosure is limited to two broad categories:
 - Listed VAT avoidance schemes: These are schemes that are described in the relevant legislation. Currently, 10 schemes have been listed
 - Hallmarked schemes: These are schemes that include or are associated with a 'hallmark' of avoidance prescribed in the relevant legislation. Currently, there are 8 hallmarks of avoidance
- Disclosure is required to be made within 30 days of (as applicable) the due date of the affected VAT return; making the claim; or the due date of the VAT return covering the period in which less non-deductible VAT was incurred

Other anti-avoidance provisions

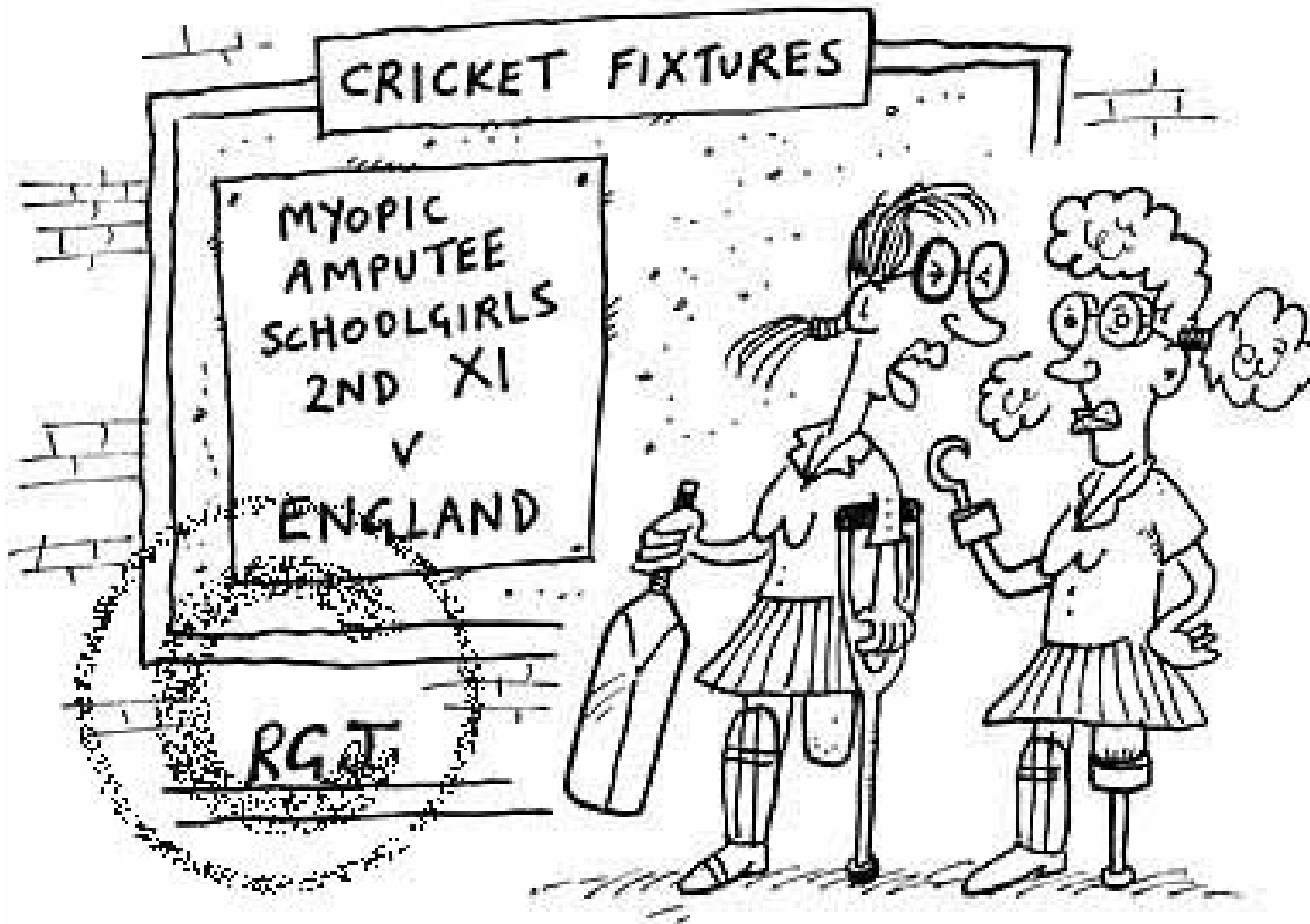
- “A” is a non-resident company for UK tax purposes
- “A” purchases land or property with the view to developing it and then selling it for a profit
- If such purchase (and subsequent sale of land or property) is viewed as an investment then “A” would be outside the scope of UK tax on the basis that it does not trade in the UK
- If, however, such a purchase (and subsequent sale of land or property) is viewed as trading income, “A” would be taxable for any gains arising out of the sale of the land
- To ensure that ‘A’ remains taxable in any event, there are anti-avoidance provisions in the UK tax legislation which ensure that
 - capital receipts arising from the sale of land or property deriving its value from land are taxable as income where:
 - the land or property deriving its value from land is acquired with the sole or main object of realising a gain from its disposal;
 - the land is held as trading stock; or
 - the land is developed with the sole or main object of realising a gain from its disposal

THE END

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"Damn it, when are we going to get some decent opposition?"