SPEECHLY BIRCHAM

July 2004

PIFs - are they worth the wait?

The long-awaited property investment vehicle looks set to be listed, closed-ended and internally managed. The listing requirement, together with strict limits on gearing, may limit its attractiveness for many property investors.

As part of the 2004 Budget proposals, the Treasury published its consultation paper "Promoting more flexible investment in property: a consultation". This is the next step in the Government's move to introduce a US REIT-style property investment vehicle into the UK – a property investment fund (or PIF).

The paper, on which representations from interested parties are being received until 16 July, addresses the Government's objectives behind the introduction of PIFs, and gives an indication as to their structure and tax treatment. In essence, the Government appears to support a listed, closed-ended and internally managed vehicle with the requirement to distribute a high level of its profits.

Below, we summarise some of the key features of the Government's proposals.

Structure of a PIF

Public listing: Access to property investment for the small investor is a key objective behind the introduction of PIFs. Consequently, the Treasury envisages that a PIF will need to be publicly listed. This will also bring the advantage (in the Government's view) of greater regulatory scrutiny.

Closed-ended: Although the paper acknowledges that an open-ended vehicle regulated by the Financial Services Authority, such as an authorised unit trust (AUT) or an open-ended investment company (OEIC), would be possible, it regards a closed-ended structure as more favourable. Many of the difficulties that are associated with open-ended vehicles due to the illiquid nature of property do not arise with a closed-ended vehicle. Investors withdraw their investment by selling their shares, and there is no need for the company to sell its assets.

Internal management: The paper appears to support an internal management structure, as this is more likely to align investors' incentives than an external management structure. It has also proved more popular in those markets where equivalent vehicles operate.

Distribution requirements: In order to fall outside the normal corporation tax rules, PIFs will be required to distribute a high level of income to their investors. The paper suggests that a minimum threshold of 90 per cent of income before depreciation would strike the right balance between an attractive distribution policy and maintaining sufficient working capital within the PIF.

The distribution of capital gains is only briefly touched upon by the paper. However it does favour the argument that all realised capital gains should be distributed immediately on the basis that this would encourage PIFs to return to the market each time they wanted to raise new capital.

Gearing: Although the US does not impose borrowing restrictions on REITs, the paper envisages that strict gearing limits will apply to PIFs. Currently, limits imposed by other countries range from 35% to 60% of the PIF's nominal share value or asset value. If such limits are imposed on UK PIFs, this would severely limit their utility to investors; it is standard for UK investors to utilise much higher gearing (even a 75% limit would be well below current UK market norms).

Commercial Property: PIFs will be able to invest in commercial property only; residential property will not be eligible for inclusion in a PIF.

Tax treatment of PIFs

A PIF would not pay tax on rental income which it receives. This would be achieved either by providing an exemption for rental income or by allowing a PIF to treat the rental income distributions to its investors as a deductible expense when calculating its profits subject to corporation tax. Any rental income not distributed would then be taxed as 'income from property' for the PIF as would any non-rental income.

The paper proposes two options for the taxation of capital gains. The first is to exempt the PIF from tax on any capital gains it realises but prevent it from distributing capital. Tax on these gains would not become chargeable until the investor sold its shares. However, this would allow the investor to defer any taxation and also reduce its tax bill further by the use of taper relief and annual exemptions. As this approach would lead to a loss of revenue for the Exchequer, the Government is likely to adopt its alternative proposal which would require a PIF to distribute all or most of

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its realised capital gains to its investors and to treat those distributions as income in the hands of those investors.

Taxation of investors

The Government is unlikely to treat the distributions to investors as dividends as this would reduce the revenue for the Exchequer: individual investors would be able to utilise tax credits whilst corporate investors would pay no further corporation tax. A more likely approach is to characterise distributions for tax purposes as 'income from property' chargeable to tax under Schedule A. Individual investors would be charged to income tax at their marginal rate on all distributions arising from income and realised capital gains. Withholding tax would apply to such distributions. For corporate investors, such distributions would be included in the company's profits and charged to corporation tax at the appropriate rate. This would not be favourable with non-UK resident investors as they would lose their effective exemption from capital gains.

Stamp duty: The paper confirms that any PIF structure would be consistent with the new stamp duty land tax regime and that no special arrangements would be introduced.

Conversion charge

It does appear that some kind of charge will be inevitable for those companies wanting to convert to (or set themselves up as) a PIF. This is likely to take the form of a conversion charge or a one-off entry charge.

Where next?

Whilst the paper sets out the Government's main proposals for introducing a new property investment vehicle to the UK, we are still a way from establishing the final structure. To this end, the Government has been looking to the property industry for guidance with responses on the paper to be submitted by 16 July. If all goes according to plan, we can expect legislation formally introducing PIFs in 2005. However, the requirement that a PIF be publicly listed, and the strict limits on gearing, mean that PIFs are unlikely to be as attractive as initially expected and many investors will continue to use offshore structures (such as limited partnerships and offshore unit trusts) to invest in UK property.

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