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**PROMOTING MORE FLEXIBLE
INVESTMENT IN PROPERTY**

A RESPONSE

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EXECUTIVE SUMMARY

Introduction

This is a summary of Dechert LLP's response to some of the key issues arising out of the Treasury's consultation paper 'Promoting more flexible investment in property'. Full details are set out later in this paper.

Enquiries about this paper should be addressed to Steven Fogel, London Managing Partner of Dechert LLP, 2 Serjeant's Inn, London EC4Y 1LT.

New investment vehicle

- **New vehicle attractive to private individuals as well as other classes of investor**: The PIF should take the form of a new investment vehicle attractive to private individuals, sophisticated investors and institutions alike. It should operate as an alternative to the structures available to such investors in the form of authorised property funds, limited partnerships and the proposed new qualified investor schemes.

Closed ended status

- **Closed ended structure**: The PIF should have a closed ended structure (i.e. investors should not be entitled to require the PIF to redeem their shares immediately for cash). This:-
 - should encourage investment for the longer term,
 - avoids the need to mix property with other, more liquid, assets to fund repayment of investors, and
 - gives investors an alternative to the more open ended UK regulated structures which may need to sell property investments on a regular basis to meet periodic redemption requests.

Such a fund is likely to be popular with investors if not over-regulated and if fairly taxed. This would promote property, encourage structural change and benefit the UK economy.

Corporate status

- **Corporate structure for PIF**: The PIF should be established as a public limited company resident in the UK and incorporated under the Companies Act 1985 or in some other appropriate jurisdiction. We see no need to make significant amendments to the Companies Act legislation. The qualification requirements for

a PIF would be set out in the tax legislation, supplemented by the UKLA Listing Rules. This would be consistent with the approach taken in relation to investment trust companies.

Public and private PIFs

- **Public and private PIFs**: We support the proposal for a PIF which is available to private individuals and all other classes of investor (a public PIF). In addition there should be a special PIF which is not available to the wider public, is not required to be listed on the London Stock Exchange and is not subject to the same level of prescription which may apply to a public PIF (a private PIF). Current legislation relating to the promotion of closed ended unlisted investment vehicles should apply to establish who is eligible to invest in the private PIF.

Listing on the London Stock Exchange

- **Public PIF to be listed**: Investors in the public PIF should benefit from a listing on the London Stock Exchange (with the potential for secondary listings on such other exchanges as may be considered appropriate by the board of the PIF). Such listings will create the potential for the establishment of a liquid market in which investors can readily buy and sell shares in the PIF. This is critical to the success of a closed ended structure where there is no other simple mechanism by which shares in the PIF may be bought or sold.

Narrowing discount to NAV

- **Policy considerations**: Listing a public PIF will not of itself create a liquid market in the shares of the public PIF nor narrow the discount to net asset value at which the shares may trade. These discounts are a cause for concern to investors because they make it difficult to obtain the full value of their investment and because it is often difficult to understand the reasons for the discount. The PIF should not be subject to any rules which might encourage the creation of discounts to net asset value.
- **High level of distribution will help reduce discount to NAV**: We support the Treasury's suggestion that a requirement to distribute a high percentage of income will encourage the creation of a liquid market in the public PIF's shares and assist in reducing any discount to net asset value at which the shares may trade.
- **PIF to determine capital distributions**: A requirement to distribute capital profits will not necessarily contribute to the narrowing of any discount to net asset value at which shares in the PIF may trade. Indeed, there may be circumstances where the erosion of the capital base of the PIF could have a detrimental effect on the operation of the PIF, its attractiveness to investors and the liquidity in the market for its shares. The board of the PIF should determine the best means of returning capital to investors both to meet their investment requirements and as a means of narrowing any discount to net asset value. The traditional means used by other closed ended investment vehicles (such as investment trusts) include market

purchases and tender offers and we favour such approaches in the case of the PIF. In addition, we consider that the board of the PIF should have the power, if they so wish, to return to investors capital gains made on assets sold. These returns should take the form of a stream of capital distributions quite distinct from the separate stream of income distributions.

Duration

- **No fixed life of PIF**: We do not support the imposition of a fixed life on the public PIF (because of the adverse effect it would have on sales of assets towards the end of its life). We believe that shareholders should be free to decide at any time whether to liquidate.

Liquidity for investors in the private PIF

- **Choice of exits in private PIF**: A private PIF should be able to become a public PIF by seeking a full listing on the London Stock Exchange. A private PIF should also be free to seek listings on other stock exchanges where this assists investors for tax or other reasons. Private PIFs should have the ability to offer eligible investors other forms of exit, either through market or non-market purchases, capital distributions and provisions relating to a fixed term for the fund or other provisions relating to its termination or continuance.

Taxation of the PIF

- **Guiding principle**: Investment in a PIF should not be taxed more than if the investor in the PIF were to invest directly in the PIF's underlying property or indirectly via existing pooled vehicles. Tax should be paid by the individual investor. There should be no 'entity level' tax, i.e. no tax payable by the PIF.
- **Income taxation**: The PIF should not be taxed on its income (rental or otherwise) so long as the prescribed level of income is distributed to investors.
- **Income distribution**: The level of income to be distributed should not be greater than 85 per cent of net rental and other income. This is similar to the standard applied to investment trusts and listed property investment companies. This level is needed to maintain sufficient operating cash within the PIF.
- **Income streaming**: The income distributions of the PIF should be streamed as separate rental and non-rental income distributions in order to match as nearly as possible the treatment of such income from direct investment.
- **Withholding**: Distributions should be subject to a basic withholding tax to reduce administrative burdens for investors and ensure consistency of tax collection. Tax-exempt investors would be able to apply to receive distributions gross of withholding to ensure the vehicle is no less attractive to them than existing alternative structures. Overseas investors should be entitled to make a similar application.

- **Capital allowances:** These should be credited to PIF investors and should not be deducted from the amount of income which is required to be distributed. Taxpaying investors should receive a tax credit referable to capital allowances that would have been available at entity level. This tax credit would reduce the withholding of tax on income (for which the investor is liable) by the PIF. This approach would ensure tax-exempt investors receive the correct proportion of the income of the PIF.
- **Capital gains - preferred approach:** The PIF should not be subject to entity level tax on capital profits, irrespective of whether such profits are distributed. Investors should only be taxed at the point of sale of their shares (though a distribution could increase the amount of tax payable on such sale). This approach is consistent with giving property the same treatment within a PIF as that available to investors in an off-shore property fund or on-shore regulated property fund.
- **Capital gains - alternative approach:** If the Treasury does not favour retention of gains in a PIF, the distribution requirement should be limited to a reasonable proportion of gains (we suggest 50 per cent) but neither the gains distributed, nor the gains retained, should suffer entity level tax. Instead, a distribution could increase the amount of tax payable on sale by an investor. In order for this regime to work, a distribution of capital would need to retain its status as capital in the hands of an investor. This is critical to ensure the liability to tax is aligned with the cost of investors' investment in their shares.
- **SDLT/SDRT:** There should be no SDLT when existing entities convert to PIF status, however that conversion is effected. Subject to that, transfers of property into and out of a PIF to third parties should be subject to SDLT at the full property rates. Transfers of PIF interests should be subject to SDRT at 0.5%.

Management

- **Choice of internal or external management for PIF:** The board of directors of a PIF should be responsible for deciding whether the management team should be internal or external (i.e. employed by the PIF or comprising people from a separate organisation). Choosing external management may be important to new PIFs and represent an important element of efficient outsourcing to existing funds.

Qualifying property

- **No restriction on nature of property:** We recognise the Treasury's need to define 'property' so that the tax status of the PIF is not abused. This is done well in the US and we advocate adopting their definition as closely as possible. It both prevents abuse and limits risk for investors. Investors in public PIFs will be able to assess the level of risk to which any particular PIF is exposed because of the requirements of disclosure on quoted companies. A US REIT (broadly speaking) must derive 75% of its income from real estate sources (including other REITs)

and 95% of its income from either real estate or other passive investment income, and thus generally is not to be engaged in any active non-real estate business. This approach, and also the ability of a US REIT to make limited investments in taxable subsidiaries carrying on a non-real estate business, should be adopted in the context of a PIF for the UK market. There should be no further restrictions on which investments will qualify for PIF investment.

Development activity

- **PIF to be able to undertake development on investment properties:** A PIF needs to be able to engage in development activity on property which is to be retained in its portfolio, in order to maximise rental income. If the PIF does development work which is treated as being trading rather than investment, this should not prejudice the tax status of the vehicle itself. Instead, any profit attributable to ‘trading’ activity should be subject to corporation tax. The distinction between qualifying investment in development activity and non-qualifying activity should be assessed by reference to the basic guidelines developed by tax case law (although that would benefit from further clarification). This approach should provide a disincentive to property development companies seeking to switch to PIF status, as they would be subject to corporation tax on most of their profits.

Borrowing

- **Market to decide acceptable levels of borrowing:** There should be no restriction on borrowing. Borrowing should be decided by the board of directors, taking into account the interest of the investors and the availability of finance in the market.

Conversion

- **Flexible methods of conversion:** There should be flexible methods by which existing entities (or combinations of entities or parts of entities) may convert to PIF status in a manner which does not give rise to unnecessary tax disincentives.
- **Conversion charge based on gains with choice of immediate payment at discounted rate or deferred payment at full rate:** PIFs should be given a choice between two ways of paying the conversion charge.
 - The first takes a similar approach to the French. The charge is imposed at the time of conversion of an entity to a PIF. It is based on the ‘embedded’ gain at that date. This embedded gain is the amount of the gain which would be taxed if the asset were sold at the date of conversion. However, a lower, concessionary, rate of tax should apply to the embedded gain to encourage conversion. If the PIF chooses this option, then, as with the French model, the charge could be paid in instalments over several years. This will ensure the PIF does not have to sell a large part of its portfolio in order to meet the conversion charge or pay tax on capital profits which are never realised.

- The second option would allow the PIF to defer payment of the conversion charge until an actual disposal of the property. But then capital gains tax would be charged at the full rate. As a concession, it would be charged on the difference between base cost and the lower of market value at the time of conversion and the proceeds of sale.

Once the Treasury has clarified the broad scheme of the charge, further consideration will need to be given to the question whether the charge should fall on the converting entity or the PIF, where two separate entities are involved.

Impact of PIFs on other fund structures

- **PIF to supplement existing investment structures:** There is currently a wide range of investment fund structures available to investors in the UK. These include authorised property funds, qualified investor funds, tax-exempt unauthorised unit trusts, limited partnerships and offshore funds. The PIF should not be viewed as a replacement for these fund structures, but rather as a new investment vehicle with its own characteristics (i.e. generally closed ended) available to the full range of investors, from individuals to institutions in the UK and abroad. However, we believe that the Revenue should consider affording to authorised property funds and qualified investor funds a similar treatment on income distributions to that which we advocate in relation to a PIF.

Tax-exempt unauthorised unit trust schemes (EUUT)

- **Role of EUUTs:** A private PIF would only become a realistic alternative to EUUTs if it were given tax, regulatory and gearing rules no less favourable than those applicable to EUUTs.

Regulatory burden and compliance costs

- **Administrative burdens for PIFs:** The Treasury's proposals should not involve any excessive regulatory or administrative burden for PIFs.
- **Correct level of regulation:** We accept that there will be a regulatory burden placed on a public PIF and its management in terms of compliance with the UKLA Listing Rules and continuing obligations. While these requirements should be kept simple and transparent, the regulatory costs in this regard are unlikely to be disproportionate to the costs to which listed investment funds in other asset classes are subject.
- **Correct absence of regulation:** If PIFs are structured as closed ended corporate entities they should not in our view be considered to be collective investment schemes. As a result, unless the manager of a PIF becomes involved in arranging advice or discretionary management activities in relation to investments, there should be no need for a manager that restricts its activities to arranging transactions, in advising on or managing property portfolios to be regulated under the FSMA. However, there will need to be persons appointed by the PIF to market

its securities and such persons would have to be appropriately regulated under the FSMA.

- **Excessive regulatory burden:** We do not favour appointed managers of PIFs being subject to regulatory requirements over and above those which may be imposed under the FSMA and, in the case of public PIFs, under the UKLA Listing Rules.

Name

- **REIT not PIF:** We prefer the fund to be termed a Real Estate Investment Trust (REIT) rather than a property investment fund (PIF). This will prevent confusion with other investment structures described as PIFs in other jurisdictions (e.g. professional investor funds in Ireland) and maximise both retail and non-retail investor recognition of the new investment vehicle.

CHAPTER 1: THE ECONOMIC CONTEXT

A.1 To what extent would a PIF (a) help to promote structural reform in the commercial property market and (b) encourage greater institutional investment and stimulate new development in the residential sector.

The introduction of a PIF is likely to increase the amount invested in property. Being equity, rather than debt, it is likely to bring greater stability to the market. The diversification offered by a pool of properties in a PIF will reduce the risk associated with investment in a single asset.

Structure of the UK property market

1.1 The UK property market has certain distinctive characteristics. These include the following:-

- a clear division between commercial and residential markets. Institutional investors rarely invest in the residential market and few individuals invest directly in the commercial market (although, of course, through pension funds and other savings products they may do so indirectly);
- a high level of owner occupation in the residential market;
- a cyclical market often dependent on debt servicing to varying levels (both in the context of commercial and residential property);
- property represents a small part of asset allocation for institutional pension scheme and life assurance investment, but plays an important part in private provision (eg through buy-to-let, SIPP's and equity release schemes).

How might PIFs affect this market?

1.2 Buying a property directly is potentially a high risk, high cost investment. Although this is true for both institutional and private investors, the risks are greatest for the latter who do not normally have access to professional investment advice and tend to have least scope for diversification. A PIF, by giving access to a pool of properties, spreads the risk so that, for example, when property becomes vacant from time to time and the fund owns other properties which continue to be income producing, then the impact of tenants leaving is less drastic.

1.3 For institutional investors the attractions of investing in a PIF, rather than directly include:-

- ***diversification*** - an investment in a PIF is in a pool of properties rather than using funds to buy a single or small number of properties. This immediately spreads the institution's risk. A PIF will also offer diversification opportunities in another sense - by investing in a specialist PIF an institution could gain exposure to new sectors of the market (e.g. residential) where it may not have in-house management expertise;
- ***tax status of PIF*** - the PIF will offer a tax efficient way in which to pool and manage funds and will encourage a liquid market in the securities of the PIF to develop;
- ***weighting*** - commentators suggest that property as an asset class is under-represented in institutional portfolios. PIFs will enable institutional investors to increase their allocation to property as an asset class through allocation to a properly managed property investment portfolio.

1.4 For individual and small private investors, the advantages of a PIF include:-

- ***diversification*** - spreading risk and avoiding some of the high risk prevalent (particularly where single assets are involved) in the current buy-to-let market;
- ***lower entry cost*** - particularly on the residential side, this is likely to bring in investors who would not otherwise be able to afford a buy-to-let property. It might reduce the need for high levels of borrowing in order to enter the market, bringing greater stability;
- ***professional and high quality management at lower expense*** - the management and maintenance resources of a PIF are likely to be greater than those of individual buy-to-let owners and the PIF will benefit from economies of scale, thus enhancing the overall standard and attractiveness of let property, to the benefit of both investors in the PIF and tenants alike.

1.5 PIFs are likely to provide a new source of equity funding. This would be of particular value in the near future. A credit crunch is predicted for 2006/7: many credit facilities come up for renegotiation, lending is for shorter terms and the effect of Basel II may be to restrict lending on property to the biggest borrowers. The benefit of the new vehicle should bring in new investors - whether institutions increasing their property weighting or retail investors (the 'mums and dads') - who could bridge the gap. The injection of a greater proportion of equity into the property sector should also reduce short termism, as (unlike debt financing) there will not be the pressure to pay down debt quickly.

1.6 The current institutional preference is for long term leases and upwards only rent reviews in the commercial market, making it an attractive low risk, high income investment. However, a wider investor base may take a different view and thereby increase the options available to the tenant. New investors attracted to the property

market by PIFs may not have the traditional expectations of upwards only income shared by the property professionals. Such investors have previously been happy to accept products whose income and value can go down as well as up and they may therefore be more open to take the risk of upwards/downwards reviews. This may not prevent ultimate disposal of those investments by the PIF to an institution: some have shown themselves to be willing to break the traditional mould e.g. Tower 42 in the City of London owned by Merrill Lynch Property Fund, and Hermes' recent acquisition of a portfolio of factory outlet centres (which have non-institutional leases).

1.7 The PIF market may well develop two models: those who (subject to the results of the ODPM's consultation on commercial property leases¹) invest only in longer term leases with upwards only rent reviews, and those who accept the higher volatility which non-institutional leases bring in return for higher rewards. Investors may welcome these choices and we suggest the PIF regime should be sufficiently flexible to accommodate them.

¹ Commercial property leases: options for deterring or outlawing the use of upward only rent review clauses, ODPM and Welsh Assembly Government May 2004.

CHAPTER 2: POSSIBLE STRUCTURES FOR A PIF

A.2 To what extent would a listed PIF close the gap with net asset value and enable a wide retail investor base? How would an unlisted PIF meet these objectives? What additional investor restrictions might be necessary?

We support the consultation paper’s view that a requirement to distribute a high percentage of income will encourage the creation of a liquid market in the shares of a public PIF and assist in reducing any discount to net asset value at which such shares may trade. A requirement to distribute capital profits will not necessarily contribute to this and may have detrimental effects. The board of the PIF should determine the best means of returning capital to investors, both to meet their investment requirements and as a means of narrowing any discount to NAV. Although we agree that certain restrictions on PIFs will be appropriate to protect ordinary retail investors, a more flexible private PIF will also be necessary to attract institutional and sophisticated investors from the current vehicles.

General

2.1 Listed property companies, like other asset rich companies, often (but not always) trade at a discount to their net asset value. Whether or not that is the case is dependant on a number of different factors, including:

- the ability of investors to participate in the full amount of the underlying value of the assets, in particular where such assets are substantial and not immediately liquid;
- the market’s view of the strength of the management team;
- the market’s view of the income stream generated from the assets and the ability of investors to receive the benefit of it; and
- the overall demand for the securities (which will in part be dependant on the above points).

2.2 A listed closed ended vehicle will not itself create a liquid market in the shares of a PIF nor narrow any gap between market value and NAV. We support the consultation paper’s suggestion (paragraphs 2.23 - 2.28) that to meet this aim PIFs should be required to distribute a high percentage of their income.² These discounts are a cause for concern to investors because they make it difficult to obtain the full value of their investment and because it is often difficult to understand the reasons for the discount. The PIF should not be subject to any rules which might encourage the creation of discounts to NAV.

² Our submission in relation to the percentage level of distribution is set out in paragraphs 4.5 and 4.6 below.

2.3 We have considered the following additional methods of reducing the NAV discount:-

- distribution of capital gains;
- redemption by market purchases;
- pro-rata redemption of shares;
- automatic share redemption at prescribed intervals;
- self liquidating funds; and
- limited life funds.

Our views as to the appropriateness of these to the PIF structure are set out below.

2.4 ***Distribution of capital gains*** - It is not clear that a distribution of capital gains will lead to a reduction of the discount to NAV and accordingly occasional distributions would not result in the market reducing any discount to NAV on a permanent basis. In addition, such distributions would have an adverse affect on the ability of the PIF to develop its assets and to fund replacement investment properties. Should management wish to acquire a replacement asset, it would be faced with the additional burden of raising finance from the market rather than being able to rely on the proceeds of a sale. This is inefficient and expensive. These disadvantages are not outweighed by any argument that raising capital from outside sources on each occasion is needed to maintain public scrutiny (as discussed in paragraph 2.10 of the consultation paper).

If the government favours a form of distribution of capital profits, we suggest that this could be achieved by way of market purchases at the discretion of the board of PIFs (see paragraph 2.5 below).

2.5 ***Redemption by market purchases*** - This is the traditional method of reducing NAV by property companies and investment trusts in the UK. The Companies Act 1985 (ss.164 and 166) and the UKLA Listing Rules (chapter 15) already provide structures for on and off market purchases and for tender offers by listed companies³. These structures could be adopted by PIFs as a means to regulate market purchases. The government could rely on guidance already provided by the ABI on the pricing of market purchases to lessen the burden of creating new regulation in this field.⁴

Listed vehicles are currently required to seek shareholder approval for market purchases. We suggest that PIFs are granted authority to make market purchases under their original

³ The tax implications of market purchases are discussed in paragraph 10.17 below.

⁴ The ABI currently suggest the price for market purchases should not exceed 5 per cent of the average middle market quotation over five business days before the purchase.

constitution. Such authority could be renewed annually or at other regular intervals by shareholders.

2.6 ***Pro-rata redemption of shares*** - Alternatively, market purchases could be structured by giving the board (or management) the power to make compulsory redemptions of shares pro-rata. This could be achieved by the issue of shares with redemption rights. Shares could be capable of being redeemed following the disposal of assets.

2.7 ***Automatic share redemption at prescribed intervals*** - This would inevitably result in a need to maintain significant cash reserves and/or the need to dispose of assets at times which may not achieve face value (see paragraph 2.15 of the consultation paper) and we would not advocate it for this reason.

2.8 ***Self-liquidating funds*** - In the US finite life real estate investment trusts (FREITS) are designed to self-liquidate over the course of time. Rather than being reinvested, the proceeds of property sales are distributed to investors and, over the course of time, the FREIT self-liquidates. As sales of properties and distributions of gains are made, the market valuation of the FREIT's shares moves closer to the projected market value of the trust's assets. This form of REIT therefore tends to trade closer to NAV.

We do not believe that this type of structure answers the need for a long term new property investment vehicle.

2.9 ***Limited life funds*** - A PIF with a specified limited life (say five or seven years) would tend to have a reducing discount to NAV over the life of the fund. Our concern, however, is that a known end date of the fund will be detrimental to the ability of the PIF management to realise best value for its assets towards the end of the life of the fund when, in effect, they could become forced sellers. If the government favours PIFs with a finite life, the exit strategy should include the option for investors either to take cash or roll their interest into a successor PIF which will acquire the remaining property assets. Such a roll-over would require appropriate SDLT exemptions.

Capital distributions

2.10 We also strongly believe that the board of the PIF should be able, subject to applicable company law, to return realised capital gains in the form of distributions alongside income distributions, where they consider this to be in the best interests of investors.

2.11 There are other methods of reducing the NAV discount, such as the issue of warrants or the creation of separate interests which are split between income rights and capital returns. We believe that the market should be left to determine whether these be offered.

Structure

2.12 We favour a corporate rather than trust structure which would normally be governed by the Companies Act 1985 and be subject to the existing corporate governance regime. The Listing Rules of the UK Listing Authority and the Takeover Code would also apply to public PIFs.

2.13 Listed PIFs should be allowed to have secondary listings on such other investment exchanges as may be considered appropriate by their board. This may increase the potential for the establishment of a liquid market on which investors can readily buy and sell shares in the PIF.

2.14 Existing public and private companies should be allowed to convert into PIFs without requiring the transfer of assets into a new company formed for the purpose. The process by which existing private and public companies convert into PIFs should not form a barrier to entry.

2.15 Corporate vehicles used for PIFs, whether public or private, should be allowed to be non-UK resident companies which are taxable in the UK. This would encourage existing offshore companies to convert to PIF status and would allow the board of non-resident companies to have greater flexibility where, for example, the rules on capital distributions may differ from those in the Companies Act 1985.

Public versus private

2.16 In addition to a listed public PIF, there should be a special PIF which is not available to the wider public, is not required to be listed on the London Stock Exchange and is not subject to the same level of prescription which may apply to a public PIF (a private PIF). Current legislation relating to the promotion of closed ended unlisted investment vehicles should apply to establish who is eligible to invest in the private PIF, i.e. non-private investors and private investors considered to be sufficiently experienced. PIFs of this type would not be subject to the limitations imposed on listed PIFs and would offer a tax transparent alternative to qualified investor funds and some forms of limited partnership.

Choice of exits in a private PIF

2.17 A private PIF should be able to become a public PIF by seeking a full listing on the London Stock Exchange. A private PIF should also be free to seek listings on other stock exchanges where this assists investors for tax or other reasons. Private PIFs should have the ability to offer eligible investors other forms of exit, either through market or non-market purchases, capital distributions and provisions relating to a fixed term for the fund or other provisions relating to its termination or continuance.

A.3 Should the property management arrangements of a PIF be prescribed through legislation?

The market should be self-regulating both as to whether internal or external management is favoured and as to the terms of any management arrangements. The success of the PIF will depend on the quality of the management which should provide sufficient incentive to ensure high standards.

Conclusion

3.1 We propose: (1) overall responsibility for managing a PIF should rest with the board who are accountable to the shareholders; (2) normal fiduciary duties under company and general law should be sufficient to regulate the actions of the board and their delegates; (3) in the case of public PIFs, existing regulations would be adequately supplemented by the UKLA Listing Rules; (4) there is no case for further legislation of external managers except where they manage under discretion or advise on the purchase/sale of shares, in which case existing FSMA rules can be implemented; (5) it is a matter for the board whether to use internal or external management and in some cases external management will be appropriate. Choosing external management may be important to new PIFs and represent an important element of efficient outsourcing to existing funds.

Background

3.2 Legislative prescription for property management would restrict flexibility of the PIF structure and might prevent management of property to its best potential. Property management per se is not a regulated activity and we do not suggest it should become so. The responsibility for running a PIF and delegating to property managers will rest with the board of the PIF who will be subject to existing fiduciary duties under company law. These duties include:-

- a duty to act honestly and in good faith in the best interests of the company;
- to take proper care of the assets of the company and to use the powers granted to them for the purposes for which they were conferred;
- directors of a company must not make a personal profit (unless permitted by the articles or ratified by the company);
- the level of skill and care to be exercised by company directors is that of a reasonably diligent person with the knowledge, skill and experience which may be expected of a director in his position together with any additional knowledge he has.

3.3 A public PIF would also be subject to further regulation prescribed through the UKLA Listing Rules, but these should not impose restrictions which prevent a flexible property management structure, whether internal or external.

We have proposed that there is a place for private PIFs in the market (see question 2) and these would be subject to the same existing company laws as public PIFs. By ensuring only 'sophisticated' investors have access to private PIFs (using FSMA criteria - see paragraph 2.15 above) there would be no need for further legislation to protect such a type of investor who is prepared to accept higher risk investment opportunities.

Why?

3.4 The success of the PIF will in part be attributable to good property management; poor property managers are therefore likely to be replaced in order to protect the value of the PIF, and investors will naturally favour better managed PIFs (whether externally or internally managed). The board of a PIF will always be accountable to shareholders and would be under the threat of having the property management outsourced if standards were not maintained. Equally an external manager could easily be replaced.

3.5 The board should be able to decide when external management is more appropriate without restriction. Specialist skills might be required (e.g. hotels, residential) or flexible management practices might be preferred (e.g. in a highly mixed portfolio) or it might simply be better for the PIF at that time to outsource the property management.

3.6 If an external manager is used, and they are dealing with not only property management but also arranging, managing under discretion or advising on the purchase/sale of shares or funds of the PIF, then they would need to be authorised under existing FSMA regulations. Existing company law (and, in the case of public PIFs, the UKLA Listing Rules) should be used to protect investors where external managers are appointed, and similar requirements appear to have been followed in other jurisdictions, for example:-

- US - if external management is used there are six or seven criteria imposed on the REIT to ensure that the appointment of the property manager is an arm's length contract. There is no prescribed form of property management agreement;
- Hong Kong - there is an obligation on the REIT to carry out proper diligence in the selection and ongoing monitoring of the property manager selected. Any form of property management agreement can be used;
- France - a SCPI (a form of private REIT) must be managed by an accredited management company with minimum capital requirements and this company must be supervised by at least seven shareholders (this in fact applies to both internal and external management of the SCPI).

3.7 It would be unnecessarily restrictive to impose a prescribed form of property management agreement for PIFs. International experience has shown that prescribed forms have not been imposed elsewhere. Forms of management agreements are already in common use in the UK without prescription (for example with joint ventures, limited partnerships or other forms of funds).

A.4 Should the minimum gross income distribution requirement be 90 per cent (before depreciation)?

We favour a basis of distributable income that follows taxable income. Capital allowances should not be taken into account at entity level.

4.1 As we note in 10.3 below, a high level of income distribution is necessary in order to justify zero tax on property rental income at the level of the PIF. We also believe this would assist in reducing the discount to NAV. Our comments below relate to the factors that we believe should be taken into account in (1) setting the basis of calculating income for the purposes of the distribution test; (2) the proportion which needs to be distributed; and (3) considering the issues relating to depreciation and whether it should be taken into account in reducing the amount which needs to be distributed.

Basis of calculating income

4.2 The relevant income which is required to be distributed (according to the relevant proportion) should be the amount of (hypothetical) taxable income. Thus, before distributing the income of the PIF it should be entitled to deduct allowable expenses of the rental business, which could include maintenance expenses and interest payments on borrowings. We do not believe capital allowances should be deducted from the amount to be distributed as that would reduce the income available to tax exempt investors upon which they would not pay tax in any event. Rather, capital allowances could be provided to investors in the form of a tax credit against withholding in relation to taxable investors. This is discussed further in the response to question 10.

4.3 Income should only be included as relevant income for the purposes of the distribution test on an after-tax basis following cash actually received. The PIF should not be required to distribute income which has suffered tax and thus any income which has been the subject of foreign withholding (e.g. dividends on shares in foreign companies) will only be required to be distributed to the extent of the amount after withholding.

4.4 The test of relevant income should exclude any form of income which is not received but instead has been deemed to be received by the PIF. An example of such deemed income is where a lease is granted subject to terms which require the tenant to carry out works on the premises where the increased value of the reversion will be

deemed Schedule A income of a landlord under s.34(2) ICTA even though no income has been received by the landlord. We also take the view that income which may be recognised early for accounting purposes should not be required to be distributed until actually received.

Distribution level

4.5 Our starting point is to achieve as much similarity as possible to the existing regime for investment trusts and offshore funds, and therefore we would prefer an 85 per cent requirement.

4.6 However, if the government does not favour an after-tax cash basis of calculating distributable income, we would expect a lower proportion of such income to be subject to the distribution requirements. The amount by which the percentage requirement is less than 85 per cent would depend on which items were not deductible in calculating income for distribution.

Depreciation

4.7 The consultation paper raises the issue of depreciation for discussion but leaves open whether ‘depreciation’ means capital allowances within the UK tax system or accounting depreciation. As recognised in paragraph 3.7 of the consultation paper, capital allowances would not be relevant to taxation at the PIF level if there is no tax at entity level. As mentioned in paragraph 4.2 above, we prefer that an amount is distributed which includes capital allowances. The reason for this is to maximise the distribution of income except to the extent of the actual costs of the property rental business, which capital allowances will not necessarily represent.

4.8 It is more likely that the deduction referred to in the consultation paper would relate to accounting depreciation. Accounting depreciation is not usually relevant to the activity of commercial property letting and thus may not be relevant or applicable. However, there is some suggestion that under new accounting standards (which may apply to certain property investors from 2005) an election to take depreciation into account for the purposes of computing profit and loss may be available. If such an election was made we would expect that the depreciation should also be taken into account for the purpose of the distribution test. It would not be automatically taken into account in calculating taxable income as property depreciation is in most cases excluded from being a deductible expense under s.74(1)(d) ICTA 1988.

A.5 What level of borrowing should be permitted in order to best deliver increased market scrutiny and stability in the property investment market?

REITs must be able to compete if they are to be successful. Their success will depend on maximum flexibility, and allowing the market to refine the product, as

the successes in other G8 countries demonstrate. Major economies, such as the US and France, do not restrict borrowing or leveraging and prefer a free market approach.

Market freedom versus investor scrutiny and market stability

5.1 The government believes that high borrowing results in high debt servicing costs, which reduces the available income to investors and moves the balance from an income return to a capital return. The greater the borrowing, the closer the structure may become to that of an ordinary property company, and the less the vehicle benefits from scrutiny in raising finance. However, the government recognises that some borrowing may be necessary to meet short term and unforeseen liabilities, and to buy and sell assets, without holding large cash reserves. Thus, borrowing will be allowed as a contingency margin. Such a margin might be achieved by a low percentage limit on the consolidated share capital and reserves or asset value. The government states that this would be consistent with a higher level of investor scrutiny, which would be required by requiring a PIF to raise capital from the markets, rather than seeking debt financing.

5.2 We disagree and favour no restriction. Based on the analysis of REITs across Europe and in the US, there does not appear to be any justification for restricting the borrowing on public or private PIFs, instead allowing a market approach to borrowing levels. Further, we do not agree that there needs to be extra scrutiny in raising finance, as such scrutiny is provided by the continuing obligations of listed companies. While it is accepted that highly geared vehicles do increase risks for investors, these risks can be properly identified by the management of the PIF and disclosed in the market. We advocate the US model as providing the correct level of investor scrutiny required by the government as the REIT market there issues capital and the analysts then decide if it is a good or bad deal. A PIF could also be made to disclose its debt servicing costs. For secured borrowings, greater use can be made of the electronic on-line public securities register through which the level of borrowings can be ascertained.

5.3 As real estate requires regular maintenance and refurbishment, there is a real risk that taking away the dynamism of having a suitable credit facility available to the PIF to draw upon at will, may hinder the management of PIFs, and the projects they may wish to undertake. As long as the investor is aware of the debt servicing costs (which largely can remain the same throughout the term of the facility) then the investor can decide what is an acceptable level of risk and costs. This must be preferable to not having a choice in the first place. Furthermore, what would be the incentive in managing a passive, ungeared vehicle?

5.4 With debt servicing costs at an all-time low (although beginning to rise), the government's proposal to turn to the capital markets for funding for each proposed development activity could prove a costly way of raising finance. Indeed, if the government were to limit a PIF's borrowing powers and combine this with a requirement for high income and capital distributions then a PIF's constant visits to the equity markets

could prove unattractive to those listed property companies who would be considering converting to become a PIF. This may well have an impact on the success of achieving the critical mass which is so important to the PIF succeeding from day one.

Benefits of borrowing

5.5 As demonstrated by the US market there may be benefits to borrowing. In the US, for geared REITs, interest on debt is a deductible expense, but principal amortisation is not; this imposes a practical limit on borrowing. NAREIT estimates the average REIT borrowing is between 40-45 per cent. In fact, the presence of leverage at the REIT level makes a REIT a very attractive investment for US tax exempt investors. US tax exempt investors who try to invest their funds directly in leveraged real estate may incur income tax liability notwithstanding their tax exempt status; by contrast, the existence of leverage in a REIT will generally not cause a US tax exempt investor's income from the REIT to be taxable (unless the REIT is a closely held entity owned primarily by tax exempts).

5.6 It is also important that the government, in restricting the borrowing of REITS, do not inadvertently close the door to other markets such as debt PIFs. Debt REITS exist in the US, in the concept of the mortgage or hybrid REIT, which use debt to buy mortgage products. The REIT tax status of a mortgage/hybrid REIT, allows a distribution of an attractive cash dividend to shareholders and thus have substantial earnings growth potential. Debt REITS are a concept which we believe may be attractive in the UK. Increased stability could come from a greater use of credit derivative and swap instruments which protect against burgeoning interest rate cycles.

5.7 The issues of scrutiny and decreasing volatility are of the highest importance to the government and, while we have discussed these concerns above, our fallback position would be that if the UK were to follow other jurisdictions, e.g. Belgium, and restrict borrowing, the government could rely on the restriction on property investment companies contained in the UKLA Listing Rules and restrict borrowing of public REITS only to 65 per cent of the gross assets of the company (consolidated where applicable). There is no need for such a restriction for private REITS.

A.6 In order to meet the government's stated objectives, and as a condition for different corporation tax treatment, should there be restrictions on the development and investment activity of a PIF, and the definition of allowable property? How should this be achieved? Any recommendations should provide a clear link to the rationale for its inclusion.

We recommend that the consequence of a PIF engaging in activity constituting a trade should be loss of the corporation tax benefits of the PIF in relation to the profits of that trade only. Definitions of allowable property and income similar to that used in the US REIT regime should be adopted in relation to PIFs.

6.1 To achieve the goal of the PIF regime to facilitate public ownership of real estate, the permitted activities and assets of a PIF should be carefully set with a view to avoiding over-regulation. Development activity should only be discouraged to the extent that the activity constitutes trading. Besides discouraging real estate activity which constitutes a trade, the PIF legislation should prescribe the maximum amount of non-real estate activity which may be comprised within a PIF. A company that enjoys the benefits of PIF status should hold assets that consist largely of real estate investments.

Development activity - trading/non-trading

6.2 There are a number of reasons why it might be desirable to limit the proportion of development activity within the PIF. One of these is the issue of risk. With rented property it is possible to assess the risks and returns of an investment. In contrast, the risks and returns on development property are often much more difficult to quantify. Those risks include the difficulty of obtaining finance, the risk of default, the lack of immediate (and uncertainty as to future) income stream and lack of liquidity. Additional policy justifications may be needed to warrant extending corporation tax benefits to substantial activity that is not passive real estate investment.

6.3 The range of development activities is broad. On the one hand, most would recognise the need for property investors to refurbish their existing assets. Similarly, it may well be considered sensible to allow investors the chance to exploit opportunities to enhance their returns by undertaking additions to or extensions of existing stock (e.g. by an extension to a successful shopping centre). Additionally, investment funds invest in new schemes by forward funding arrangements. These are an integral part of the process of investing in real estate. On the other hand, however, the business of developing property in order to sell at a profit, but not to derive income from the property (which would be treated as trading for tax purposes), should not be eligible for the full tax benefits of a PIF.

6.4 A PIF should not only be a vehicle for holding previously developed property, as this would prevent a PIF from maximising returns from its rental activity by extending property or developing for retention. There should be neither a blanket restriction on investment in development projects nor a hard and fast maximum percentage applied. There would be significant difficulties in deciding the correct basis for any specific tests for maximum permitted development activity. For example, how would a fixed proportion be assessed? Would it be by reference to net asset values, existing and/or projected, or gross cost of funds employed in 'development activity' (whatever that is

decided to mean) as a proportion of gross portfolio value? Such legislation would also have to provide for changing circumstances. For example, what if a development activity is initially projected as a permitted investment but due to unforeseen delays or cost overruns or significant adjustments in market values results in the PIF breaching the prescribed tests? We therefore recommend that the UKLA Listing Rules' percentage-based restrictions on property investment companies carrying out development activities should not apply to PIFs.

6.5 There should be no restrictions on a PIF engaging in development activity on property for retention within the PIF. If the PIF does development work which is treated as being trading rather than investment activity, this should not prejudice the tax status of the vehicle itself. Instead any profit attributable to 'trading' activity should be subject to corporation tax. The distinction between qualifying investment in development activity and non-qualifying activity should be assessed by reference to the basic guidelines developed by tax case law in relation to the trading/investment distinction. Drawing from the experience of US REITs, if a PIF wittingly or unwittingly oversteps the mark, rather than lose PIF status, it would instead lose the beneficial corporation tax treatment to that extent. This would act as a sufficient disincentive to true property development companies converting to PIF status: the tax benefits of doing so would largely disappear. However, we expect the regulatory/listing regime to require disclosure of development activity and that funds with a high proportion of development activity would more typically take the private PIF format we have suggested at paragraph 2.15 above.

6.6 Where a PIF receives trading income taxed within the PIF, the remaining income after tax could be distributed to investors and would be taxed again in their hands as a dividend (refer to paragraph 11.1 below). A tax credit may be appropriate.

6.7 The current guidance on the distinction between property investment and trading activity looks at a number of factors, such as the motive for acquiring the property, the method of finance, whether the property is income producing, the period of ownership and others. In many cases the manner in which the properties are recorded in the accounts will be highly indicative and this should give a measure of certainty to the tests. However, as the tests can be difficult to apply in borderline cases, further clarification of the distinction may be required. There should, for example, be some guidance as to the length of time a property needs to be retained for it to be presumed an investment holding.

Allowable income

6.8 Apart from the issue of whether development activity constituting a trade should be allowed in a PIF, it is necessary to consider to what extent the PIF may be entitled to income from non-real estate activities. The PIF legislation should specify a percentage of the PIF's income that must be passive income from real property.

6.9 Our view is that the market should be left to decide which classes of real property investment will be attractive to PIFs and which PIFs will be popular to investors and

attract funding. However, certain activities identified in the consultation paper (such as the operation of hotels, leisure, storage units, and public projects such as hospitals, prisons and infrastructure) are business operations and will, in many cases carry significantly higher risk of fluctuations in income as compared with passive rented property. For example, in the hotels industry yields will be determined by occupancy rates which historically are subject to greater volatility than yields on passive rented property. The service element of these activities (as opposed to the property ownership function) will not generally constitute real estate income and thus should not represent a main or major component of a PIF's activities without further policy justifications.

6.10 The PIF legislation should therefore include a minimum income requirement, i.e. a minimum percentage of the income of the PIF which must be derived from real estate. We advocate adopting the US approach whereby a US REIT must (broadly speaking) derive 75 per cent of its income from real estate sources (including other REITs) and 95 per cent of its income from either real estate or other passive investment income.

6.11 These restrictions should not prevent PIFs from investing in 'marginal' projects such as infrastructure projects, as this could potentially help raise the quality of residential property supply in areas poorly served by local infrastructure.

Allowable assets

6.12 Drawing from the US model, we suggest that a PIF should not be prevented from enjoying the full income potential of various types of real property by investing to a modest extent in trading activities that it could not otherwise undertake itself. A PIF could therefore own taxable subsidiaries which are tenants of PIF-owned assets, but which themselves operate service businesses such as hotel management or running serviced offices.

6.13 As with the test of allowable income, in relation to assets the US REIT rule should be adopted and thus at least 75 per cent of the value of the total assets of the PIF must consist of 'real estate assets'.

6.14 To provide flexibility for the PIF, 'real estate assets' should include mortgages on property, shares in other PIFs and mortgage backed securities. As noted above, the PIF should be permitted limited holdings in trading companies. PIFs must be permitted to reinvest capital proceeds in liquid form pending initial investment or reinvestment in real estate assets.

6.15 Consistent with the distinction between income from real estate held for investment and income from trading activities, the definition of 'real estate assets' should include land and all the structural and mechanical components of buildings, but should not include assets used in the trading activity such as machinery and furnishings. As an example, fitness equipment installed at a leisure centre would not be regarded as a real estate asset, but the structure of the building would be an eligible asset for the purposes of the 75 per cent test.

6.16 We see no reason why a PIF should be prevented from investing in non-UK property. While many of the advantages to the government of introducing a PIF regime are based on PIF investment in UK property, a PIF could be strengthened by the diversification achieved by investment in overseas property.

Meeting the government's objectives

6.17 The ability for PIF managers to choose the type of eligible investments for a PIF from a wide selection could allow a wider choice of savings products (with a wider choice of risk/return profiles) to be available to investors in PIFs. For example, a manager may wish to manage one PIF with a relatively high risk/reward profile aimed at more sophisticated investors, while at the same time launching a much more stable property investment fund aimed at retail investors which could raise its profile as a manager in the market. Allowing a breadth of choice is essential to attract significant additional capital, while simultaneously attracting significant management talent to the property market.

A.7 How could the structure of a PIF be designed to ensure a better quality of stock? Is a minimum holding period appropriate, and if so how long should the period be?

Competitiveness between PIF providers and economies of scale should increase efficiency of property management and underlying asset quality. But the requirement for income distribution should not be set at such a high level that the PIF cannot maintain the property properly. A minimum holding period is unnecessarily inflexible.

7.1 A more flexible market, facilitating regular turnover of properties, will result in greater efficiency and increased productivity in the economy. A more liquid market, with increased flows of equity, should of itself ensure greater frequency of renewal of assets and enhanced quality of stock. The transparency of the structure (particularly if the PIF is to be a listed vehicle) will result in increased competitiveness, which should be reflected in higher standards of management and ultimately better quality stock. The indications from US and Australian REIT markets suggest that the economies of scale achievable through large-scale REIT vehicles again have positive effects on management and underlying asset quality. This is of particular relevance to the UK residential market, where large institutional portfolios are currently rare.

7.2 To ensure better quality of stock, it is important that the income distribution percentage is set at a realistic level that allows sufficient funds to be allocated to management and maintenance costs. The ability of the PIF to enhance asset quality by way of refurbishment and redevelopment would be significantly increased if capital gains

were allowed to be retained, tax exempt, for reinvestment purposes. For further consideration of these issues, see paragraph 10.14 below.

7.3 The requirement for a minimum holding period is an unnecessary restriction which could add to the perception of a PIF as a less attractive property holding vehicle than other more flexible schemes available. It is not a feature of the majority of international REIT structures. A restriction on the ability to dispose of property would limit flexibility by preventing the PIF from reacting to positive or adverse market conditions, potentially exposing the PIF to higher risk, and restricting the ability to act in the best interests of investors.

7.4 Any requirement for a minimum holding period coupled with a relief mechanism enabling earlier disposal, e.g. by general resolution of unit holders (as was introduced in 2003 in the Hong Kong REIT market), should also be discouraged as it would be expensive, time consuming, and difficult to implement in practice.

7.5 Any minimum holding period might also affect the SDLT take, if it resulted in properties in PIFs being traded less frequently than those held as direct investments.

A.8 How could a PIF deliver high quality residential property for the entire range of rented accommodation, and what features of a PIF would help to achieve this aim, while meeting the objective to ensure no overall cost to the Exchequer?

Carrots (eg further inducements to invest in residential property) are likely to be more effective than sticks (eg obligations to have a minimum residential holding).

General

8.1 The Barker review makes a number of observations relevant to PIFs:-

- much of the private rented sector is held by individual buy-to-let landlords;
- these owners are generally highly-g geared and sensitive to interest rate risk;
- they often have low standards of property maintenance and management; and
- there is a lack of badly needed large-scale residential developments.

8.2 Private investors who view property as a desirable long-term growth investment need an alternative to the low diversification, high borrowing, high risk buy-to-let market. The PIF should be able to provide these investors with a comparable income and capital return involving less borrowing and lower risk.

8.3 Institutional investors in the US have had and continue to have an appetite for large-scale residential assets (even some subsidised housing), as a proper asset class in a diversified portfolio. In contrast, historically in the UK, outside the buy-to-let market, residential property has not been attractive to institutional investors. The government may desire to use the PIF initiative to stimulate the residential sector and make it a more attractive investment for institutions. As discussed in reply to question 1 above, one of the structural changes to the UK property markets that may result from the PIF initiative is a blurring of the sharp distinction between commercial and residential property, and a corresponding increase in interest by institutional investors in residential property. An appropriately structured PIF affords the opportunity to stimulate development of this asset type. As institutional investors bring institutional standards of maintenance and management to the residential sector, standard should rise.

Minimum investment requirement

8.4 The consultation paper suggests that all PIFs should be required to have a minimum investment in residential property. Although this might appear to serve the goal of stimulating development of residential property of all classes (including affordable and social housing) at no cost to the government, we believe it is more likely to inhibit the growth of PIFs by its attempt to force property companies to invest where they may have no interest or expertise. The laudable goal of stimulating the residential market should not outweigh the more important goal of flexibility for the PIF; the PIF should be able to elect to be specialised or diversified, depending only on market preferences. Institutional investors in residential properties have historically wanted specialised management. The US market (without this type of regulation) has developed specialised REITs (including residential REITs) in response to investor appetite for specific property types managed by specialised managers.

8.5 A ‘stick approach’ - forcing every PIF to invest in residential assets - may discourage the take up of PIFs. ‘Carrots’ may work better.

Features of a PIF that may achieve the government’s housing goals

8.6 Proposals, other than the minimum investment requirement, to use the PIF legislation to the advantage of the residential sector would require enhanced tax benefits to PIFs that invest in housing; the resulting losses of revenues to the government would be offset by increased SDRT/SDLT, and tax revenues from PIF investors on the increased stock of residential assets and their increased liquidity.

8.7 Although we do not recommend a minimum residential investment requirement, we do recommend that the PIF legislation favour the PIF that has committed a significant percentage of its capital to residential assets (the ‘ResPIF’). Examples of advantages that might be afforded to the ResPIF (any one or more of these might be considered in the PIF legislation) include:-

- a lower tax rate at the investor level on rental income distributions from residential assets;
- to the extent that the government determines that only equity PIFs (i.e. non-borrowing PIFs) will be authorised, provide an exception for the ResPIF, allowing it to elect to be an equity, debt or hybrid (a combination of debt and equity) PIF. An equity PIF that has the benefit of other tax advantages for ResPIFs, and would also have access to debt from a debt PIF should be able to achieve some yield advantage over other assets;
- while we do not recommend that the government prohibits PIFs generally from engaging in development activity, if the final PIF legislation includes such a restriction, or sets a maximum on a PIF's exposure to development, an exemption should be provided to allow the ResPIF to engage in non-trading development activities or to engage in them at a higher percentage;
- if the PIF legislation includes a requirement to distribute capital gains, allow the ResPIF to retain a greater percentage of its capital gains for reinvestment, perhaps only for purposes of new development (i.e. only the gain would be reinvested in the higher risk development activities), or capital improvement of existing assets;
- a PIF that holds a minimum amount of residential property should be afforded an advantage, in the form of either a deferral or a discount, from SDLT on transactions involving its assets.

8.8 These advantages for the ResPIF would be supplemented by existing non-PIF housing legislation and possible future reforms intended to encourage investment in residential property, such as tax credits and expedited planning approvals such as the reform to Planning Policy Guidance 6.

8.9 It is unlikely that even a ResPIF will have a direct effect on affordable or social housing, because that sector suffers from a funding gap and other impediments that inhibit investor and developer interest. It is likely, however, that if PIFs cause a general increase in the supply of housing at higher pricing levels, the elimination of housing shortages will dampen inflationary pressures across the entire housing sector. Increased capital to the residential sector may provide liquidity to enable transfers of housing at the lowest end of the market into housing associations.

A.9 How could a PIF be structured to encourage greater flexibility for occupiers in the commercial sector? What conditions could be set for PIF landlords to ensure high standards in both residential and commercial sectors?

PIFs must have a level playing field with other property investment vehicles - they will not succeed if they labour under greater restrictions than other landlords. The

government should learn the lesson from the failure of the over-restrictive Housing Investment Trusts.

9.1 In view of the government's current consultation on upwards only rent reviews in commercial leases⁵ affecting the industry as a whole, it would be premature to discuss any such change in the isolated context of PIFs.

9.2 Any restrictions on the form of PIF lease provisions would result in difficulties in practice. PIF landlords could be precluded from acquiring portfolios of existing leases with non-compliant provisions; and the terms of any underlease to be granted by PIF landlords may be prescribed by the headlease itself, preventing compliance by the PIF with any legislated conditions. Monitoring and enforcement of compliance would be likely to be costly and difficult to achieve in practice.

9.3 Imposing a condition that PIF leases must make provision for both upwards and downwards rent reviews would significantly affect the security of income traditionally associated with property as an asset class, and result in the loss of differentiation from equities and other asset classes which are vulnerable to market fluctuation. A product that is potentially subject to diminishing returns as a result of a fall in the rental market is likely to command a significantly lower share price than one whose security of income is guaranteed. It goes without saying that the Revenue's share of distributed rental income would be similarly affected by a fall in market rents. Nevertheless, the PIF market may well be prepared to accommodate these risks and develop two models, one of which may accept the higher volatility which non-institutional leases with upwards and downwards rent reviews may bring.

9.4 A change in focus from capital gain to income production should result in an increase in the tendency towards shorter lease lengths (and more flexible lease terms) in any event, as shorter leases (and appropriately priced flexibility) generally result in higher income returns. However, recent surveys suggest that occupiers are in the majority of cases unwilling to pay higher rents in return for increased flexibility when given the option.

⁵ Commercial property leases: options for deterring or outlawing the use of upward only rent review clauses, ODPM and Welsh Assembly Government May 2004.

CHAPTER 3: TAX IMPLICATIONS OF A PIF

A.10 To ensure no overall cost for the Exchequer, what is the most appropriate system for taxation at the PIF level? Is it appropriate to require a PIF to distribute a high proportion of realised capital gains to investors?

Our basic principle is that investment in a PIF should be taxed no more than if the investor had invested directly in the underlying property or indirectly via one of the existing pooled investment vehicles.

General

10.1 Investment in a PIF should not be taxed more than if the investor were to invest:-

- directly in the underlying property of the PIF; or
- indirectly via existing pooled vehicles.

10.2 Guaranteeing an efficient and fair level of tax for investors is an essential element in ensuring the success of PIFs. In order to succeed, PIFs must represent a tax efficient investment option to promoters and the investment community at large who will be potential investors in a PIF e.g. private individuals, UK corporates, institutions, life companies, tax exempt investors and offshore investors. The attractiveness of a PIF to a wide community of investors is in turn vital in promoting a liquid market in the shares and actively minimising any discount to NAV represented by the price at which shares readily deal on an exchange. If the vehicle proves only attractive to a small category of investors this may not create sufficient liquidity in the shares as a listed investment. We expect that a more liquid market in the shares could provide some compensating increase in tax revenues to offset any reductions as a result of beneficial tax treatment.

Income

10.3 We agree that a PIF should not be subject to tax on its net rental income provided the required proportion of its income is distributed to investors to ensure continuity of Exchequer receipts. See our comments in reply to question 4 above regarding the appropriate level of distribution. The net rental income distributed should be assessed as rental income in the hands of investors with the result that such investors should be entitled to all the same tax deductions (such as the investors' own pooled deductible expenses and losses) as if they had been a direct owner of the property to ensure tax neutrality. Further, the rates of tax applicable to each class of investor in respect of a direct investment would apply in order to ensure the vehicle is no less attractive from a tax perspective. Thus, in relation to this income, individual investors will be taxed at their marginal rate, corporate investors at corporation tax rates, offshore investors at 22 per cent and tax exempt investors such as pension funds and charities will not pay tax.

10.4 There may be occasions where substantial non-rental income is received by the PIF in the normal course of its operations (see our response to question 6 regarding the limits on such income receipts). For example, pending investment in underlying properties the PIF may hold substantial liquid assets in cash deposits, gilts and other forms of money market instruments. In addition, pending distribution of the capital profits of any disposal similar income may arise. We recommend that this income should also not be subject to tax within the PIF to the extent that it is distributed, but instead it should be taxed in the hands of investors as if they had received such income directly.

10.5 This distribution approach in relation to both rental income and non-rental income may require the PIF to make two classes of distribution in respect of income which is not taxed at entity level:-

- a rental income distribution; and
- a non-rental income distribution.

10.6 We do not expect that the streaming of distributions will give rise to significant extra complexity for individual taxpayer investors as basic rate taxpayers will have no further tax to pay. The information necessary for higher rate taxpayer investors to complete their tax returns we envisage would be contained in the PIF annual statement of returns issued at the end of the investors' tax year in much the same way as occurs with unit trusts.

10.7 In the case of both rental and non-rental income distributions, the amount of income distributed would be, as advocated in response to question 4, net income profit for tax purposes. Thus, before the income is distributed it will, in relation to rental income have had the expenses of the PIF's rental business (e.g. maintenance and management expenses and interest) deducted and in relation to non-rental income any relevant expenses and interest. Further, any losses of the rental business should also be first deducted on existing tax principles so that the PIF is not forced to distribute income when it is in an overall loss position over a period of years. Such a principle as regards distribution of income is in line with the approach taken with REITs in the US. As stated in our response to question 4, our preferred approach is that capital allowances are not deducted in calculating income for distribution but should instead be made available to investors in the form of a credit against tax withheld by the PIF (see paragraph 10.12 below).

10.8 Non-qualifying income, i.e. income from trading, should be taxed at entity level at corporation tax rates. The untaxed proportion can be distributed to investors as a separate class of distribution which would be subject to tax in the hands of investors as dividend income. While there may be some advantage in attributing losses incurred at the level of the PIF to an investor (e.g. equal treatment for investors coming in at different times) we would imagine this would involve extra administrative burdens for investors and instead such losses should be deducted from the proportion of income to be distributed to investors.

10.9 As mentioned above, items deductible for tax purposes at the level of the PIF (were it to be subject to tax) are available to reduce the amount of income that needs to be distributed. This should not prevent investors setting any allowable expenses or losses of their own against the relevant class of distribution. Thus, for example, a distribution of net income from the PIF (after the PIF's expenses have been deducted) would not all be subject to tax in an investor's hands if the investor could set off property letting expenses from direct property investments. This approach will afford consistent treatment with an investment in a pool of properties in which all deductions in the pool are available for set-off against taxable rental income to the extent possible.

Withholding tax

10.10 We recommend a withholding system in relation to rental income distributions and non-rental income distributions. This has two advantages:-

- it ensures security of receipts for the Exchequer in relation to certain classes of taxpayer upon whom assessments are more difficult to raise. This would assist in fulfilling the government's aims of tax neutrality for the PIF project; and
- it ensures basic rate taxpayers have no further tax to pay and need not file a tax return.

10.11 The rate of withholding in relation to the respective streams of income should reflect the current rate of withholding tax on similar income streams, eg 22 per cent on rental income and 20 per cent on interest. Non-residents should be permitted to apply to receive rental income distribution payments gross under a modified non-resident landlord scheme and to receive non-rental income distributions gross pursuant to a relevant double tax treaty. A similar application could be made by tax exempt investors which we imagine would contain a suitable self-certification.

10.12 As mentioned in paragraph 10.7 above, capital allowances available to the PIF should not be deducted from the amount of income which is required to be distributed, but instead should be made available to PIF investors. The reason for this is that tax exempt investors would not wish the proportion of income distributed to them to be reduced in this way. Instead, investors who have not obtained permission to receive income gross of withholding would receive a tax credit referable to capital allowances that would have been available at entity level. This tax credit would reduce the withholding of tax on income (for which the investor is liable) by the PIF.

Capital gains

10.13 In order for the PIF to be a successful investment vehicle (and relative to other options for investment in property) tax on capital profits within the PIF should be kept to a minimum. An important aspect of this is ensuring the minimum discount in share price to NAV. For example, UK investment properties are often held in overseas companies to

prevent (subject to anti-avoidance rules) capital gains arising at entity level. Investors within the UK capital gains tax net would not bring their investments onshore into the better regulated structure of the PIF unless the entity level capital gains treatment was as beneficial as the overseas property holding company. In addition, offshore unit trusts are also not subject to capital gains tax on gains arising.

10.14 Our preferred approach is that there should be no entity-level tax on capital profits, irrespective of whether such profits are distributed to investors, and investors should only be taxed at the point of sale of their shares. Such an approach would be consistent with treating property as an asset class in exactly the same way as more liquid forms of investment held within UK regulated investment companies and authorised unit trusts. It is also our view that there should be no compulsory distribution of capital.

10.15 As regards a non-distribution approach we note from the consultation paper that there is some concern that such an approach would give rise to a loss to the Exchequer. We believe this need not be the case if a truly liquid market in the shares of the PIF is achieved. The alternative approach suggested in the consultation paper is that there would be no tax on capital profits to the extent distributed, and such profits as are distributed would be immediately taxed in the hands of the investor. To be practicable, such a regime must be capable of taking into account the capital expenditure of the investor in acquiring shares. This is particularly important as the shares may be priced with reference to the unrealised capital gain. To achieve this, a distribution of capital would need to retain its status as capital in the hands of an investor and should allow the investor's acquisition cost to be taken into account. It should not be deemed property rental income as this would unfairly penalise overseas and tax exempt investors and reduce the appeal of PIFs relative to offshore vehicles and undermine their success. Our preference (by contrast to the consultation paper) is that even if there is no requirement to distribute capital, a distribution should not give rise to an immediate charge to tax in the hands of investors. Instead, upon a distribution of capital investors' base cost in their shares should be reduced increasing the amount of tax payable on sale of their shares. Only if the distribution were to take the base cost below zero would this give rise to an immediate tax charge at the time of distribution. We believe that an alternative regime providing for a deemed disposal on capital distribution would be difficult if not impossible to administer successfully.

10.16 If the government does not favour retention of gains in a PIF tax-free, our fall-back approach is that there should be a requirement to distribute a reasonable proportion of gains (we suggest 50 per cent) but that neither the gains distributed nor the gains retained should suffer entity-level tax. Instead, a distribution should affect the investor's tax position as suggested with our first choice of approach. Therefore, upon a distribution of capital, the investors' base cost in their shares should be reduced, increasing the amount of tax payable on the sale of their shares. Only if the distribution were to take the base cost below zero would this give rise to an immediate tax charge at the time of distribution.

Share repurchases

10.17 The repurchase of PIF shares would receive similar tax treatment in the hands of investors as the repurchase of shares by any other corporate body. Thus, a repurchase of shares by a public PIF on the market would give rise to a charge to tax on capital gains for investors, but in any other case a repurchase of shares would give rise to an income tax charge on the amount by which the proceeds exceed the nominal value of the share and premium on issue. The remainder would be taxed as a capital gain.

A.11 Given the impact of characterising distributions from a PIF as dividends, would the option to treat distributions from a PIF as income from property, taxed at UK investor's marginal rate, pose any unforeseen problems?

Distributions by a PIF should not be treated as a dividend for tax purposes.

11.1 We agree that distributions by a PIF should not be treated as a dividend for tax purposes (except in relation to non-qualifying income - see paragraph 6.16 above) and for the reasons set out above the simplest approach is to view the distribution as a distribution of the relevant income source or capital directly paid to the investor.

11.2 We see no difficulty in that part of the distribution falling within the rental income distribution stream being treated as income derived from property and the non-rental income and capital gains if distributed being treated as non-rental income or capital gain arising to the investor directly. As mentioned above, withholding would apply so that basic rate and overseas taxpayers would have no further tax to pay in relation to rental and non-rental income distributions.

A.12 In the context of the modernised stamp duty system, and the wider tax implications for different types of property investment, the Government invites views on what the appropriate liability for Stamp Duty Reserve Tax (SDRT) and Stamp Duty Land Tax (SDLT) should be for a PIF and investors in a PIF. This should reflect the objective to ensure no overall cost to the Exchequer.

We are in favour of a 0.5 per cent rate applying to transfer of PIF interests - other transactions need to take the conversion charge into account.

12.1 Our view is that the rates of SDLT applying to property (1, 3 and 4 per cent) may be applied to transfers of property to a PIF subject to a relief for PIF conversions. However, transfers of interests by investors in PIFs should be subject to stamp duty and

SDRT in the same way as shares in a company and should be taxed at 0.5 per cent rather than property rates.

Property transfers

12.2 In order to prevent avoidance of SDLT the transfer of a property into a PIF (other than on conversion) would need to be subject to SDLT at property rates. It is open to the government whether it wishes to treat the PIF as transparent for SDLT purposes or similar to a corporate vehicle. Our preference is treatment similar to a corporate entity, mainly for the sake of simplicity, so that it is not necessary to apportion between investors the value of property transferred in and out of the PIF. Applying the corporate model, on acquisition of a property by a PIF, SDLT would be paid by the PIF on the full market value of the property, whether the property was transferred/contributed by an investor or a third party. However, there should be no SDLT when existing entities convert to PIF status by whatever means that conversion is effected.

12.3 If, as suggested below, the 0.5 per cent rate is applied to transfers by investors of their PIF interests, it might be said that PIFs could be used for SDLT avoidance. However, we do not see a major risk of this as investors would not wish to incur the initial 4 per cent (maximum) charge on property transferred in to the PIF. Any relief in relation to the conversion charge would not be used for avoidance as converting entities would not wish to incur the conversion charge (even if reduced by an SDLT conversion relief) merely to avoid SDLT.

PIF interests

12.4 The sale of an interest in a PIF should be regarded much like the sale of an interest in a company. PIF interests will be designed as a liquid investment which (as is anticipated by the consultation paper) would be listed and easily tradable; it seems hard to distinguish such interests from company shares. The lower liquidity of property as compared with shares (and thus reduced transaction volume) is often used to justify the increased stamp taxation incurred on property transactions, but such an argument would not apply to sales of indirect interests in property via an interest in a PIF. Furthermore, the reduction in liquidity caused by the position of a significant charge on the transfer of PIF interests could widen the discount of PIF share value to NAV. Minimising such a discount is an important goal of the PIF, and it would be unfortunate if the position taken on stamp taxes prevented progress on this issue.

12.5 Furthermore, to impose a 4 per cent charge on purchase of an interest in a PIF could put off overseas investors.

Exchequer neutrality

12.6 Using this approach we suggest that there would be little difference to the SDLT take from a given sample of property over a given time period. As SDLT would be paid in full on transfer to the PIF, and a purchaser from the PIF would also pay SDLT at full

property rates, this might be similar to the SDLT take from a direct holding over a similar period, unless PIFs were said to hold on to property longer than other investors (perhaps another reason for not imposing a minimum period of holding - see response to question 7 above). Any consequent loss of tax take by virtue of a longer holding period might well be offset (or even exceeded) by the increased revenues from transfers of interests (chargeable at 0.5 per cent) in PIFs taking place more often than interests in unlisted entities that currently undertake property investment.

A.13 What implications would International Accounting Standards (IAS) have for a PIF.

13.1 We make no comment on this as others are better placed to do so.

CHAPTER 4: TRANSITIONAL ISSUES AND A CONVERSION CHARGE

A.14 The Government is interested, in the context of ensuring no overall cost to the Exchequer, in the factors it should take into account in setting the scale, nature and timing of the conversion charge to a PIF.

The conversion charge should follow a capital gains basis; we favour giving the PIF an election to pay the charge at a discounted rate on conversion or at a full rate when the property leaves the PIF.

General

14.1 The government's decision on the nature and size of the conversion charge for the PIF will be one of the principal factors determining whether the initiative will succeed. An unattractive conversion charge will discourage conversion, putting at risk the large-scale adoption of PIF status that is essential to achieving the goals of the PIF initiative. A sufficiently attractive model would not only contribute towards the success of PIFs, but could also assist in encouraging the repatriation of capital that is now in offshore property vehicles. The French SIIC displays a pragmatic government approach to inducing rapid large-scale conversion. However, the SIIC model may need to be modified for the UK in order to encourage a critical mass of PIF participants and taking the particular circumstances of the UK into account.

14.2 If the PIF legislation is sufficiently attractive in its adopted form and includes relief from tax on capital gain that is distributed, the resulting conversions are likely to increase investment and transaction volume in property. The Exchequer could expect as a consequence to recover lost capital gains tax revenues through an increase in SDRT /SDLT revenues on greater trading volume in property and in PIF shares.

Nature of charge

14.3 The appropriate starting point for a discussion of a conversion charge is the principle that the charge should bear a relationship to the revenues that will be lost to the Treasury in according to PIFs the relief from tax on capital gains as advocated above. In our view this would favour a charge based on the accrued but unrealised (i.e. 'embedded') capital gain in the converting company, as is the case in France with SIIC conversion. A charge based instead on net assets on conversion (without regard to base cost) would discriminate against companies that have recently acquired property assets with the intent to hold them long-term, while favouring companies with large embedded gains. It would also prevent converting companies from using tax losses to mitigate the conversion charge. A net assets charge would thus have the result that the conversion charge would collect revenues that would not otherwise have been available to the Exchequer.

14.4 An important principle of the conversion charge should be that it allows freedom for property owners to choose between a variety of means of achieving PIF treatment without tax or the conversion charge being a factor in that choice. The charge should result in the same overall charge whether (1) an existing owner converts to PIF status without involvement of a new entity; (2) property is transferred to a PIF for cash consideration; or (3) property is transferred/contributed in return for an issue of shares in an entity formed as a PIF.

14.5 We believe that a conversion charge should have the following features in order to recover as closely as possible the long term capital gains tax loss to the Exchequer as a result of the beneficial tax treatment accorded to a PIF:-

- in addition to acquisition costs the converting entity should be entitled to set off capital losses in the entity or reassigned to that entity under s.171A Taxation of Chargeable Gains Act 1992;
- conversions by entities which are not within the charge to UK capital gains tax (e.g. offshore companies and tax exempt persons) should not involve a conversion charge. This is important to incentivise repatriation of offshore funds. It also acknowledges that to subject such entities to tax on conversion would result in the collection of revenues that would not otherwise have been available to the Exchequer; and
- stamp taxes should be taken into account in setting the conversion charge applicable. Where the investors remain the same before and after conversion, there should be a relief from SDLT as the property will not ultimately have changed hands.

French SIIC conversion charge model

14.6 The French conversion charge offers a useful example that might be adapted for the UK market.

14.7 Since September 2003, when French legislation allowed French listed property companies to convert to SIICs, the market capitalisation of SIICs has leapt. This was the result of the substantial tax break afforded to property companies which converted: instead of facing capital gains tax on sales of assets at the rate of 35 per cent, companies converting to SIIC status could pay the one-time exit tax on embedded capital gains at the reduced rate of 16.5 per cent, and pay it over four years. The impact on the French treasury of the tax relief afforded to the converting companies was offset by the immediate infusion of tax on gains that might not have otherwise been realised for many years. This inducement resulted in a French REIT market with a substantial critical mass and an increase in trading volume. SIICs have seen their share prices rise and discounts to net asset value have shrunk.

14.8 We recognise that the SIIC model may provide less of a revenue boost in the UK as compared with France for a variety of reasons. UK companies have generally been able to mitigate more capital gains tax. UK property owning groups often hold property through subsidiaries in offshore jurisdictions such as Jersey and thus avoid UK taxation on gains, and UK companies do not have the same level of embedded gains as French property companies - an estimated 22 per cent of French property companies' net worth is comprised of capital gains tax liabilities; compared to only 8 per cent of FTSE 350 property companies.

14.9 But notwithstanding the differences between the UK and French markets, the exit charge in the form of a tax on embedded gain at a discount from capital gains tax on sale is likely to provide the needed stimulus to conversion while giving a large short term revenue boost. The discount must be sized to reflect the differences from the French market, particularly the attractiveness of competing vehicles. Permitting payment of the exit charge over time (as noted above, the French allow payment over four years) may not be necessary if the discount is sufficiently attractive; but a modest discount may be sufficient if combined with a deferral.

14.10 In France, only listed companies may have the benefit of the conversion charge discount. This limitation should not apply to PIF conversions as there is no reason to distinguish public and private PIFs in this respect - both forms of PIF market should be equally encouraged.

Our suggested model

14.11 PIFs should be given a choice between two ways of paying the conversion charge:-

- The first takes a similar approach to the French. The charge is imposed at the time of conversion of an entity to a PIF. It is based on the 'embedded' gain at that date. This embedded gain is the amount of the gain which would be taxed if the asset were sold at the date of conversion. However, a lower, concessionary, rate of tax should apply to the embedded gain to encourage conversion. If the PIF chooses this option, then, as with the French model, the charge could be paid in instalments over several years. This will ensure the PIF does not have to sell a large part of its portfolio in order to meet the conversion charge or pay tax on capital profits which are never realised.
- The second option would allow the PIF to defer payment of the conversion charge until an actual disposal of the property. A charge on capital gains would however be charged at the full rate at that time. As a concession, it would be charged on the difference between base cost and the lower of market value at the time of conversion and the proceeds of sale.

14.12 The charge would apply only to conversions by entities within the charge to tax on capital gains in the UK.

Recapture on failure to qualify

14.13 The difference between a full rate and the reduced rate applying at the time of conversion could be recaptured (whether in whole or in part) upon a PIF ceasing to qualify. We suggest that this should be the only backward-looking consequence of a PIF ceasing to qualify - it should then only be subject to corporation tax in relation to future profits.

SDRT/SDLT

14.14 On purchase or sale of property to or by a PIF, the Exchequer would expect to receive a tax take equivalent to SDLT. Our view is that there should be no difference in the tax treatment as between conversion of an existing entity which is not a transfer for SDLT purposes or a transfer of property to a PIF. Parity may either be achieved by reducing the conversion charge by the amount of SDLT payable where there is a transfer for SDLT purposes or providing an exemption from SDLT in those circumstances.

Further issues relating to the conversion charge

14.15 In addition to the broad scheme of the conversion charge that we recommend, there are certain more detailed questions that need to be addressed. We do not attempt to resolve these questions, as the answer to these may depend on the type of regime chosen by the government. These include, for example, the following:-

- would the PIF be entitled to be a member of a capital gains group for the purposes of the conversion charge?
- where a conversion involves two entities, will liability for the conversion charge fall upon the PIF or the entity which transferred property to the PIF?

CHAPTER 5: WIDER IMPLICATIONS

A.15 With no other changes in taxation, what impact might the introduction of a PIF have on alternative options for property investment? What, if any, are the implications for the distribution rules for authorised investment funds?

The introduction of a PIF will complement, but not necessarily replace, the structures currently available which we suggest should be retained.

15.1 There is a wide range of investment fund structures currently available for property investment:-

- ***retail authorised property funds*** in the form of authorised unit trusts and OEICS. These have in recent years had limited success given the regulatory requirement to allow investors to invest or redeem at least twice a month and hold a minimum weighting of 20 per cent in more liquid assets. The proposal to move to notice periods for redemptions of up to six months should enable these to have larger weightings in property. However, the need to provide liquidity will mean these vehicles will invest in properties offering greater liquidity in smaller lot sizes. They offer investors an income stream plus the advantages of liquidity linked to net asset value. In addition, their tax treatment is attractive. There is no tax on gains at entity level and such funds are subject to corporation tax on income at the rate of 20 per cent. Income distributed to investors derived from dividend income of the fund is treated as a dividend in the hands of investors and is entitled to a tax credit. Where the income of the fund is derived from interest on debt securities it is taxed as interest income in the hands of investors.
- ***non-retail qualified investor schemes*** These are likely to prove popular to higher net worth investors and institutions looking for an investment structure which is not constrained by regulatory restrictions on the type of property that can be held and spread and concentration. They also hold the promise of a greater level of borrowing in investment terms. As with the more authorised AUTs and OEICs they offer the advantage of liquidity linked to net asset value and an income stream. The tax regime for these funds is currently under consideration by the Treasury. We understand that one of the proposal is for the tax regime on these funds to follow that of authorised property funds set out in the previous paragraph.
- ***Exempt Unauthorised Unit Trusts*** These are restricted to tax exempt investors such as pension funds and charities. They offer promoters wishing to invest in property for these clients the option of doing so in a tax efficient manner. There is no tax at either entity level or in the hands of investors on gains and provided the appropriate vehicle is used there will be no tax on income either. They are also not constrained by investment restrictions or borrowing restrictions.

Accordingly, promoters can establish flexible vehicles to access varied property investment propositions.

- *offshore funds* both closed and open ended to varying degrees. Offshore property funds offer promoters a flexible structure to establish funds with multifaceted investment objectives and exit strategies. For example the funds may be open ended with long or short notice periods. Alternatively they may be closed ended but with limited liquidity provisions. These types of structures can accommodate a geared or an ungeared investment approach. The tax is also attractive to investors. The funds will generally not be subject to tax on gains and will be subject to tax on income only at the rate of tax applicable to non-resident landlords being 22 per cent.

15.2 We believe that a closed ended vehicle such as a PIF would be an attractive addition to the above structures for a number of reasons:-

- it would offer a closed ended vehicle which could invest in a long term manner in property without the constraints of offering early liquidity;
- being listed and publicly available it would be accessible to the retail investor and would offer an attractive alternative to the retail AUT or OEIC.

We do not see it as a replacement to a retail fund or a qualified investor fund. Retail OEICs will continue to be attractive to retail investors seeking exposure to a fund with a more liquid investment portfolio. This may include property investments and more liquid investments such as shares in property companies including PIFs. Private PIFs would however offer a flexible vehicle likely to be aimed at a more specialist and non-liquid mandate than those offered in a public PIF.

15.3 However, to succeed the public PIF must be a liquid vehicle and it must trade at no or a low discount to NAV. In addition it must have an attractive tax treatment both on an absolute basis and relative to the vehicles referred to above. Failure to achieve the desired tax treatment would not be beneficial for the liquidity of the market for its shares.

15.4 As indicated above in the response to question 10, it is important that distributions of income (rental and non-rental) and capital are treated as distributions of the relevant kind in the hands of investors for tax purposes to ensure that the vehicle is attractive to all classes of investor. Otherwise many classes of investor could choose to stay invested in the existing vehicle options and the PIF market may not take off. However, we believe that the Treasury should consider affording to authorised property funds and qualified investor schemes a similar treatment on income distributions to that which we advocate in relation to PIFs.

A.16 What role and contribution can Unauthorised Unit Trusts (UUTs) continue to make to the wider objectives of reform set out in this document?

The introduction of a PIF will complement, but not necessarily replace, the structures currently available which we suggest should be retained. UUTs will not necessarily be replaced by the introduction of a PIF and, we believe will continue to have a useful role to play, particularly in relation to tax exempt investors.

16.1 For the purposes of this response UUTs are taken to mean UK-resident unauthorised unit trusts. UUTs come in two basic forms, unauthorised unit trusts which are not restricted to tax exempt investors (an 'EUUT') and UUTs which are so restricted. UUTs (unlike authorised unit trusts) are not themselves subject to regulatory controls relating to their investment objectives and powers but may not be sold to retail investors. The manager of a UUT will however be required to be regulated by the FSA and is therefore subject to the Conduct of Business rules of the FSA relating to its management of the UUT. In addition, the Conduct of Business rules impose additional controls over management of such funds.

16.2 Generally speaking, UK-established UUTs have only proved attractive where available to investment by tax exempt investors such as pension funds and charities. Such UUTs have historically been used by managers and advisors to provide investment vehicles for the full range of tax exempt investors which invest in a wide range of asset classes including both property and securities. Unless the UUT is constituted as an EUUT disposals by the UUT will be charged to tax on capital gains. Income paid by UUTs to investors is subject to deduction of tax as an annual payment, and therefore will be less attractive to tax-exempt investors unless, in the case of pension fund investors they invest in a UUT established as an approved pension fund pooling vehicle, and in the case of charity investors, they invest in a UUT established as a charity common investment scheme or similar. Where UUTs are established as such vehicles, there will be no tax on income either at entity level or at the level of the investor. UUTs provide the only format in which all tax exempt investors can invest and may thus also prove attractive in a wider variety of circumstances.

16.3 If an emerging PIF regime includes private PIFs which are subject to less stringent regulation on borrowing, investment in development property, and other areas of risk exposure, a PIF may become a realistic alternative to UUTs for tax exempt investors. A private PIF could also only become a realistic alternative to UUTs if it were given the correct tax treatment. This would require a facility for tax exempt investors to be able to apply to receive distributions of income gross of withholdings.

16.4 However, we do not think that investors in an EUUT would convert to a PIF in respect of all structures. An EUUT structure is an attractive way for a number of institutions to seek skilled outside management of their property exposures using varying investment objectives and criteria. It is not clear that a closed ended PIF would wish to have the same investment objectives. Nor is it clear that pension funds would necessarily

wish to swap market liquidity with the prospect of liquidity at a price near to net asset value.

16.5 In our view the ongoing role of UUTs needs also to be considered in the light of the availability of the ‘qualified investor fund’ status as an outcome of the FSA CP185 consultation. We doubt, however, that qualified investor funds would be an attractive proposition for tax exempt investors (see 15.1 above) unless there was a means by which income would not suffer tax at the level of the fund where the fund is invested in wholly by tax exempt person.

16.6 We therefore believe that there remains a real role for the EUUT and that the future of the vehicle be determined by investor choice and not regulatory prescription.

A.17 What are the main reasons for the lack of interest of Investment Trusts participating in housing? Is there any reason why this legislation should not be repealed?

It is important that the lessons of the HIT regime are taken into account in the design of the PIF regime - particularly the need to ensure the vehicle is attractive to a sufficiently large body of investors in order for it to succeed.

17.1 The Housing Investment Trust (‘HIT’) introduced in 1996 aimed to make use of the existing investment trust regime to provide a listed vehicle for investment in residential housing with certain tax benefits. The vehicle is taxed at the small companies’ rate of 19 per cent on income at entity level, and there is no taxation in relation to capital gains.

17.2 There has been a very low take-up of the HIT format. This is believed to be due to the following factors among others:-

- HITs can only invest in properties that are acquired for a consideration of £85,000 (£125,000 in the Greater London area). The sharp increases in residential property prices over recent years have greatly reduced the number of properties which can be comprised in a HIT;
- HITs are restricted in the types of real estate interests in which they can invest. They can only invest in freehold interests or long leases with minimal ground rent. Furthermore, if the interest is subject to anything other than a short hold tenancy, the interest will not qualify;
- the existence of tax on income at the small companies’ rate is unattractive to tax-exempt investors such as charities and pension funds who might be expected to comprise a substantial proportion of investors in HITs;

- there has been some doubt as to whether the listed investment trust format is the best choice for the residential sector, as a HIT requires substantial market capitalisation in order to be eligible for listing on the London Stock Exchange. Due to the restrictions on qualifying residential property, it may have been difficult for HITs to reach the necessary size; and
- investors in residential property may also wish to have commercial property investments to balance their portfolio, and such investments could not be comprised in a HIT.

17.3 If a tax regime is created for a PIF which is attractive to all types of likely investors, we hope that the HIT would be superseded by the PIF, which would be more likely to reach critical mass due to the wide variety of property in which we hope the PIF could invest. If true tax transparency is reached for income as well as gains, that would further obviate the need for the HIT regime.

A.18 If a PIF were to be introduced, what would be the most appropriate method for evaluation?

18.1 We make no comment on this as others are better placed to do so.

A.19 The Government would welcome views on whether these proposed changes would significantly increase regulatory burden and compliance costs, and if so how?.

19.1 We do not believe it would be beneficial to impose significant regulatory burdens and costs on the proposed REIT structure.

19.2 Accordingly, as indicated above, we do not favour appointed managers of PIFs being subject to regulatory requirements over and above those which may be imposed under the FSMA and under the UKLA Listing Rules.

19.3 If the PIFs are structured as closed ended corporate entities they should not in our view be considered to be collective investment schemes. Even if they are, we do not think that a third party manager should be considered to be the operator of the scheme for the purposes of the FSMA. As a result, unless the manager of a PIF becomes involved in arranging, advising or discretionary management activities in relation to non-property investments, there should be no need for a manager that restricts its activities to a manager of property to be regulated under the FSMA. However, there will need to be persons appointed by the PIF to market its securities and such persons would have to be appropriately regulated under the FSMA.

19.4 We accept that there will be a regulatory burden placed on a PIF and its management in terms of compliance with the UKLA Listing Rules and continuing

obligations. While these requirements should be kept simple and transparent, the regulatory costs in this regard are unlikely to be disproportionate to the costs to which listed investment funds in other asset classes are subject.

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APPENDIX 1
GLOSSARY OF TERMS USED

ABI - Association of British Insurers

FREITs - Finite life Real Estate Investment Trusts (US vehicle)

FSA - Financial Services Authority

FSMA - Financial Services and Markets Act 2000

ICTA - Income and Corporation Taxes Act 1988

NAREIT - National Association of Real Estate Investment Trusts (US representative body)

NAV - net asset value

Qualified investor schemes - a fund authorized as a qualified investor scheme by the FSA pursuant to the FSMA which is marketed only to sophisticated and experienced investors

SCPI - Sociétés Civiles de Placement Immobilier (Civil Real Estate Investment Companies). SCPIs invest directly in real estate and their shares may be purchased by the public, although they are not listed on a stock exchange, as the shares are not negotiable securities.

SIIC - Sociétés Immobilières d'Investissement Côtées. SIICs, which were created by the French Finance Law for 2003, are listed companies which invest on a long term basis in real estate assets to be leased either to businesses or as dwellings or in shareholdings in companies having the same purpose.

UKLA - United Kingdom Listing Authority

**APPENDIX 2
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