

PROPERTY INVESTMENT FUNDS – A REALTY OPPORTUNITY? PART 1

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On March 17 2004, the UK Treasury announced a consultation exercise on how property investment funds ('PIFs') in the UK should be structured to encourage more efficient investment in commercial and residential real estate.² The consultation paper reveals that the UK Treasury is contemplating a tax-neutral vehicle which will be well-regulated and appeal to the small investor by boosting liquidity. In order to ascertain the ultimate benefit of PIFs to the UK economy and potential real estate investors and to try to understand what vehicle we should end up with in the UK, this two part article will examine the characteristics of real estate investment trusts ('REITs') currently operating in the US and throughout Europe and compare their appeal to global real estate investors and how respective government's successes (and failures) have formed current vehicles.

Part 1 of this article looks at REITs in the US, France and Germany. Part 2, which will be published in the July/August issue of the Journal, will examine REITs in Belgium and Luxembourg and make suggestions as to the kind of vehicle which should be adopted in the UK for a PIF.

If readers do have comments on the Treasury's consultation process, the Editor, Hugh Pigott via Ann Phillip at (ann.phillip@lexisnexis.co.uk) or Andrew Petersen (andrew.petersen@dechert.com) would be pleased to hear them.

In any event all consultation responses by email should be sent by 16 July 2004 to: (PIFconsultation@hm-treasury.gsi.gov.uk).

INTRODUCTION

ILLIQUID REAL ESTATE?

Even though commercial real estate in the UK has been the top-performing asset class over the past decade, rightly or wrongly, over the same period, direct ownership of such real estate has gained a perception of being illiquid, inaccessible for private investors, tax inefficient for financial institutions and, dare it be said, expensive. As a result, recent years have seen real estate investors across the globe seeking to make indirect real estate investment risk-averse and ideally tradable. This has led to a growing market of investors wanting to invest in real estate in a unitised way. To accommodate this need, limited partnerships, limited liability partnerships and offshore unit trusts are just a few of the structures which have developed to allow investors to 'pop in' and 'pop out' of real estate whilst at the same time limiting liability and achieving beneficial tax treatment. Real estate investors in every G7 country, other than the UK, have also had the advantage of REIT-type vehicles – essentially tax transparent collective property investment vehicles formed for the purpose of holding assets which are unitised like shares. This article will examine those vehicles in order to analyse what form the PIF should take and what form should be avoided.

WHY INTRODUCE PIFS?

The absence of PIFs in the UK has encouraged a flow of investment offshore. Through the introduction of PIFs, it is hoped to stem this flow and redirect the £25bn or so of UK real estate investment into a properly-regulated onshore investment vehicle, thereby protecting UK tax revenues.

A typical REIT offers a number of advantages to both private and institutional investors:

- it allows accessible indirect investment in real estate – participants can invest in a professionally managed portfolio of real estate that is held in tax-transparent funds that trade shares rather than the underlying assets. This may serve to open up real estate investment to the small investor who otherwise could not have had this investment opportunity;
- it enables participants to broaden their investment portfolio and diversify risk;

- it is tax transparent. There is only one level of taxation, namely, at the shareholders' level. The REIT does not pay tax on its profits thereby maximising dividends to shareholders who then pay tax on their dividends and on profits made when they sell their shares. Typically a US REIT will pay back at least 90 per cent of its profits to its shareholders and in many cases even more than that, with some REITs distributing all their profits to their shareholders. REITs can also serve to eliminate some of the tax and other difficulties experienced by institutional investors, such as pension funds and foreign investors, if they invest more directly in real estate;
- it provides ease of liquidation of assets into cash. One reason for the liquid nature of REIT investments is that the shares of many REITs are primarily traded on major exchanges, making it easier to buy and sell REIT assets/shares than to buy and sell real estate in private markets;
- it has an advantage over stocks and bonds in terms of dividends. All REITs are required to pay dividends whereas other companies are not and, as REITs must distribute almost all their taxable income as dividends to shareholders, they instil confidence in the marketplace;
- it offers low historical volatility. REITs tend to be stable and, therefore, offer an attractive return for investors;
- it has no minimum investment. Additionally, since REITs must be widely held, they are ideal candidates to be public companies.

The raft of property investment vehicles which have been created over the last decade demonstrates the depth of institutional enthusiasm for a PIF type structure. Hammersons have converted to a SIC in France, and the medical charity, the Wellcome Trust, recently announced that it was planning to transfer its whole portfolio into a holding company in order to attract investment for its research work. Such a holding company could well be converted into a PIF – which could generate more cash for Wellcome and its investors.³ Moreover, Isis Asset Management has recently launched a £240m 'REIT-style' listed property trust for private investors, which, given that it will pay no Corporation Tax or Capital Gains Tax ('CGT'), will have gearing of around 40 per cent and will distribute much of its profits to shareholders. It holds property in the office, retail and industrial sectors and has been billed as the first fund the nearest in structure to a REIT.⁴ Consequently, when PIFs arrive in the UK, they will be competing in a fierce market and their restrictions and regime will have to be attractive enough for them to become the preferred ownership vehicle for real estate investors – as they have become in the US.

US REITS

The US REIT was created by the US Congress in 1960 for the purpose of making real property an investment option for the small investor. However, it was not until 1986, when as a result of some dramatic changes in the tax laws, there was a significant increase in REIT investment. These changes may be instructive to those involved in the UK PIF initiative.

The original REIT rules imposed an 'all or nothing' qualification test. A REIT that failed to comply in any respect with the rules, for example, by 'actively engaging in a trade or business', albeit unwittingly, lost its tax qualification entirely. Today a REIT is taxed (at the rate of 100 per cent) on its income from non-qualified transactions, but will not lose its REIT status entirely with its compliant income still having the benefits of the REIT dividend deduction.

Moreover, REITs originally were required to be passive investors, prohibited from operating or managing assets. Management could only be by independent third parties (whose interests were not fully aligned with those of investors). Today, REITs may 'operate' and provide customary services for most types of real property, and so can be internally managed. REITs now may own taxable REIT subsidiaries (although not more than 20 per cent of total asset value can consist of shares of taxable subsidiaries), that may operate service businesses such as hotel management, day-care centres, golf courses, hospitals and nursing homes as tenants of REIT-owned assets.

MARKET FREEDOM?

The UK Treasury's consultation paper suggests that it may be appropriate to restrict the market freedom of a PIF, but the success of REITs is an argument for maximum flexibility, allowing the market to refine the product. The REIT regulations do not regulate:

- whether REITs are closed or open-ended. The UK Treasury shows a preference for requiring all PIFs to be closed-ended as a way of bringing share prices in line with net asset value. The US markets have, without mandating closed-end REITs, developed the finite life real estate investment trust ('FREIT') in recognition of the share to net asset value disconnect. The FREIT has a termination date by which it must liquidate all of its assets. This reduces exposure to interest rate risk and induces investors to factor in expected capital distributions in valuing share prices;
- the amount of gearing or leveraging. For geared REITs, interest on debt is a deductible expense, but principal amortisation is not; this imposes a practical limit on gearing. The National Association of Real Estate Investment Trusts ('NAREIT') estimates the average REIT gearing is between 40 – 45 per cent.⁵ 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 directly invest their funds 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). This may also be an attraction in the UK and should pass the Treasury's tax neutral requirement;
- whether the REIT distributes or reinvests its gains on sales of assets. Net capital gains on sales of REIT assets are subject to income tax at the REIT level if retained. If distributed to shareholders as a capital gain dividend, the gain is not taxed at the REIT level, and is taxed to the shareholder; individual shareholders can take advantage of the lower long term capital gains tax rates. The ability to retain capital allows for continued maintenance and upgrading of assets when costs of capital rise;
- the type of property a REIT may invest in. In the US, there are both diversified and properties, and health care or self-storage facilities.

Conversion to REIT status can generate tax liability for capital gains realised when property is contributed to a REIT in exchange for cash or shares in the REIT. The 'UPREIT' and 'DOWNREIT' structures have developed to minimise and/or defer the tax impact of contributing property to a REIT; assets can be contributed to one or more limited partnerships (controlled by the REIT), in exchange for limited partnership interests that can be traded for REIT shares. Again, the UK could take advantage of this.

PUBLIC VERSUS PRIVATE?

The REIT regulations do not regulate whether a REIT is publicly traded (ie listed on a recognised exchange) or privately traded. NAREIT reports 171 publicly-traded REITs at 2003 year-end, and estimates that approximately one-third of all REITs are private.⁶ Institutional investors favour public REITs for the quantity and quality of initial and ongoing disclosure and reporting required under the US securities laws for public companies; more than 50 per cent of REIT shares are owned by institutional investors, about 15 per cent by retail public investors, and about 17 per cent by REIT management.⁷ At year-end 2003, the 171 publicly-traded REITs had a total market capitalisation of about \$224bn.⁸ Of the estimated total US real property market of \$4.6tn, about \$180bn (or 4 per cent) is held by public REITs.⁹ REIT shares are liquid; about 80 public REITs held investment grade ratings by Moody's, and 70 by Standard & Poor's; daily trading volume in REITs is about 12 million shares.¹⁰ As these figures demonstrate, the strength of the US REIT market is the best argument for the UK Treasury to take a minimalist approach to regulating the PIF, allowing it maximum adaptability which will translate into larger market capitalisations and liquidity.

FRENCH REITS

INTRODUCTION

France recognises various types of real estate companies.¹¹ However, two types of real estate companies correspond generally to the notion of REITS: Sociétés Civiles de Placement Immobilier – (Civil Real Estate Investment Companies) ('SCPIs'), and the Sociétés Immobilières d'Investissement Côtées – ('SIICs'). 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. SIICs, which were recently created by the French Finance Law for 2003,¹² 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.

SCPIs

SCPIs are subject to strict regulations as regards the type of investments they may make, the information they give out to the public, their management, and more particularly the system of share transfers. However, various recent reforms¹³ have reduced certain restrictions on SCPIs and have granted a specific tax regime to SIICs, making those investment vehicles more attractive. As a result, a SCPI:

- must have as its exclusive purpose the acquisition and management of a rental real estate portfolio, whether for dwelling or commercial purposes. Subject to strict conditions, an SCPI may undertake maintenance, repair, improvement, rebuilding and expansion works. For example, the cost of extension may not exceed 30 per cent of the market value of the property and 10 per cent of the SCPI's portfolio. Moreover, the cost of any rebuilding work on real estate owned by the SCPI cannot exceed 10 per cent of the total value of the SCPI's real estate portfolio. A SCPI may sell its real estate assets only if four conditions are met:
 - the sales do not constitute the company's usual activity;
 - the sales transactions do not have a speculative purpose;
 - the sales are not made less than six years after the property has been purchased; and
 - the cumulated value of the real estate being sold does not exceed 15 per cent of the market value of the SCPI's portfolio (assessed at the end of the last tax year);
- is managed by a 'société de gestion' (management company) accredited by the AMF,¹⁴ and supervised by a supervisory board consisting of at least seven shareholders. The SCPI must also appoint a real estate expert who makes a yearly report on the valuation of the company's real estate portfolio. Each real asset must be separately valued at least once every five years;
- must have a minimum capital of €760,000 and at least 15 per cent of the capital must be subscribed by the public within one year of opening of subscription;
- must have shares in nominative form and must have a par value of at least €150. However, the shares can be transferred either over the counter or on the secondary market by the management company. Pursuant to the 2002 reform, a complex system has been put in place in order to protect investors in SCPIs, which basically consists in the management company matching sale and purchase offers as closely as possible;
- is not subject to corporate tax and is tax transparent. Revenues received by shareholders are subject to the personal (or corporate) income tax in the real estate income category. In case of sales of shares, capital gains are treated as real estate capital gains. In addition, registration taxes (droits d'enregistrement) in the amount of 4.80 per cent on the price on shares in SCPIs are due upon transfer;
- permits non resident investors to be subject to a 25 per cent withholding tax on dividends distributed by the SIICs, subject to treaty relief or reduction (which generally reduces the withholding rate to 15 per cent for minority investors and to 5 per cent for parent companies).

Moreover, mirroring a post *Barker* report aim, recent French legislation¹⁵ offers tax advantages to encourage owners of real property, including SCPIs, to invest in housing projects, whether in older or new constructions, and in particular to lease their property in favour of low income individuals. The main advantages relate to the granting of a tax depreciation of the investment made in a SCPI and tax deduction of any rental revenues received from the SCPI.

SIICs

Essentially, SIICs are French corporations with a minimum share capital of €15m listed on a French exchange and whose principal corporate purpose is the purchase or construction of real property to be leased out, or the direct or indirect investment in companies having the same corporate object.

SIICs are subject to corporate income tax, but may opt for a tax transparent regime in exchange of their undertaking to distribute dividends. Pursuant to this preferential tax regime two types of profits

are tax exempted at the corporate level: profits from rental of properties and capital gains from the sale of such properties as well as from the sales of companies which they own. However, in order to benefit from the special regime, profits from rentals must be distributed in the amount of at least 85 per cent before the end of the financial year following the year in which such profits were made. At least 50 per cent of any capital gains which were tax exempted must be distributed within two financial years of the sale in order for the exemption to continue to apply. SIICs may operate their business outside France, however, the preferential tax regime only applies to French assets in SIICs' portfolios.

Shares of SIICs are also eligible for tax-efficient saving schemes such as plans d'épargne en actions or PEA (share savings plans) which makes them attractive to individual investors as well. In order to induce large French property companies with older building portfolios (and hence large latent capital gains tax exposure) to opt in to the SIIC regime, recent legislation provided for a one time exit tax of 16 per cent on all capital on gains on real estate portfolios.

GERMAN OEFs

Germany has well-established tax-transparent property vehicles in the form of the open-ended real estate funds ('OEFs') and in 2003, the OEF market was worth €14.43bn. From the investor's perspective, OEFs are similar to REITs – paper assets that are backed by properties, tax exempt on the corporate level, and have the possibility to accumulate or disperse assets in small lot sizes. Like US REITs, OEFs also accept contributions from individual private investors and then pool resources to buy real estate that would otherwise be out of the financial reach of those investors. Unit shares can be returned to the fund at any time at the going bid price.

Capital investment companies that offer OEFs are regulated by a comprehensive and tight legal framework, regulating such legal aspects as licensing requirements, the organisational structure, the function and purpose of custodians, permitted investments, investment restrictions, valuation, accounting, auditing and publication requirements. The state supervision of the rules codified in the Investment Act is exercised by the federal financial supervisory authority – BaFin. In 2002, the 4th Financial Market Promotion Act facilitated the ability of OEFs to invest internationally outside the European Union and the European Economic Area. Before the Act, it was only possible to invest 20 per cent of the fund's capital outside the Eurozone. Now 100 per cent of the fund's capital may be invested internationally, as long as their unhedged currency exposure does not exceed 30 per cent of the fund's capital.

However, with the introduction of the Investment Modernisation Act 2004, the German real estate industry hoped for the introduction of 'true REITs' and the establishment of a laissez faire market approach which in turn could boost the suffering German real estate economy. Unfortunately, the Investment Modernisation Act fell short of allowing properties and property companies to serve as possible investment vehicles of investment stock corporations and the establishment of 'true REITs', is currently ruled out under German legislation.

Notwithstanding this, future amendments to the act should give investors the choice, in the real estate field, of investing in an investment stock corporation or a fund separate from the assets of the company and interest groups are already lobbying to transform Germany into a large REIT market. The introduction of 'true REITs' could avoid the tight regulation concerning OEFs, resulting in an opening up of the real estate market to investors who are ready to take a higher amount of risk than the traditional investors in OEFs (and who are expecting a considerably higher return from their real estate investment). Such a move could present the German OEFs with a tough challenge, by putting pressure on their capital inflows if investors choose to switch their money into listed REIT vehicles.

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1 The name may change to reflect the financial structure and the government (in an indication that they may not be happy with PIFs as a name) has welcomed alternative suggestions. After all, it could not have been called a Property Investment Trust (after the Housing Investment Trusts of the 1990s), since one could imagine the take up in a product called a PIT to be relatively low.

2 See http://www.hm-treasury.gov.uk/budget/budget_04/associated_documents/bud_bud04_adproperty.cfm

- 3 See *Housing Today*, 20 February 2004 p15.
- 4 See *Property Week*, 16 April 2004 p23. The fund will be a Guernsey -exempt investment company with its shares listed on both the London and Channel Islands stock exchanges. It will offer investors a target yield of 6.75 per cent, as well as the potential for income and capital growth.
- 5 See <http://www.nareit.org/researchandstatistics/>
- 6 See <http://www.nareit.org/researchandstatistics/>
- 7 Fass, Peter; Shaff, Michael; and Zief, Donald, eds Real Estate Investment Trusts Handbook (Thomson 2004), at p5.
- 8 Fass, Peter; Shaff, Michael; and Zief, Donald, eds Real Estate Investment Trusts Handbook (Thomson 2004), at p5.
- 9 Fass, Peter; Shaff, Michael; and Zief, Donald, eds Real Estate Investment Trusts Handbook (Thomson 2004), at p5.
- 10 Fass, Peter; Shaff, Michael; and Zief, Donald, eds Real Estate Investment Trusts Handbook (Thomson 2004), at p5.
- 11 Société Civile Immobilière, SCPIs, SII, sociétés de location immobilière transparente or sociétés immobilières de copropriété transparentes.
- 12 Law no. 2002 – 1575 of 30 December 2002.
- 13 *Règlement COB* No 2001-06, Decree of 26 April 2002.
- 14 The management company may be either a *société anonyme* (corporation) (whose capital must be at least €25,000) or a *société en nom collectif* (commercial partnership) with the condition that at least one of its partners is a *société anonyme* having a minimal capital of €25,000.
- 15 Law No. 2003 –590 of 2 July 2003.