

# PROPERTY INVESTMENT FUNDS – A REALTY OPPORTUNITY? PART 2

Andrew Petersen, Dechert **LLP**\*

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On March 17 2004, the UK Treasury announced a consultation exercise on how property investment funds ('PIFs')<sup>1</sup> in the UK should be structured to encourage more efficient investment in commercial and residential real estate.<sup>2</sup> 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, which was published in the June issue of the Journal, looked at REITs in the US, France and Germany. Part 2 examines REITs in Belgium and Luxembourg and makes 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](mailto:ann.phillip@lexisnexis.co.uk)) or Andrew Petersen ([andrew.petersen@dechert.com](mailto: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](mailto:PIFconsultation@hm-treasury.gsi.gov.uk)).

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## BELGIUM

In 1995, Belgium enacted legislation permitting the creation of 'sociétés d'investissement à capital fixe en biens immobiliers' ('SICAFIs') or closed-end real estate investment companies. Prior to that time, the only publicly-offered collective investment medium for real estate investments in Belgium was the

real estate certificate ('certificat immobilier'). The real estate certificate, which continues to be available on the Belgian market, is a type of asset trust certificate which entitles the holder to a ratable share of the net income and gain from an underlying real estate asset (typically, a single building leased to one or more tenants).

The major differences between the certificat immobilier and the SICAFI are the latter's greater diversification of risk, its association with the active management of the underlying real estate portfolio and its greater liquidity.

## **REGULATORY REGIME**

The legal framework for SICAFIs was established by the Royal Decree of 10 April 1995 issued under the Law of 4 December 1990, which is the basic Belgian law governing collective investment funds and investment companies. Like other investment funds and companies, a SICAFI must be approved for public offering by the Belgian Banking, Finance and Insurance Commission ('BFIC'). A SICAFI must be established in corporate form and, with limited exceptions, may invest only in 'real estate assets'. Such assets may include not only buildings, but also options, leasehold interests and other rights in buildings, voting shares of real estate companies related to the SICAFI, and real estate certificates.

The SICAFI's investments must be diversified in such manner as to assure a spreading of investment risk according to the investment policy set forth in the SICAFI's articles of association. Subject to possible derogations granted by the BFIC, a SICAFI may not invest more than 20 per cent of its assets in any single real estate project. For corporate accounting purposes the SICAFI's assets are appraised periodically by an independent chartered surveyor, based on prevailing market prices; the assets are recorded in the SICAFI's financial statements at their appraised value and are **not** depreciated. A SICAFI is permitted to leverage its assets by borrowing but its total debt is not permitted to exceed 50 per cent of its asset value (determined at the time each new borrowing is contracted). A SICAFI is also required to distribute at least 80 per cent of its annual net income on a current basis.

## **TAXATION**

Although SICAFIs are, in principle, subject to Belgian corporate income tax, like other investment companies their taxable income is limited by Decree to the amount of any non-arm's-length benefits transferred to them by related parties and to the amount of certain miscellaneous items which are not tax deductible. Hence, in practice, SICAFIs are essentially exempt from Belgian corporate income tax. Withholding taxes withheld on dividends paid to a SICAFI may be credited against any tax payable by the SICAFI and any excess will be refundable. On the other hand, property tax payable by the SICAFI in its capacity as owner of buildings in its portfolio, although constituting in principle a tax-deductible expense, will in practice not generate any tax deduction given the absence of mainstream corporate income tax liability. Dividends paid by a SICAFI to its shareholders are subject to a withholding tax of 15 per cent, except that no withholding tax is payable if at least 60 per cent of the SICAFI's portfolio consists of Belgian residential real estate. Dividends paid to foreign investors can also qualify for a reduced rate of withholding tax under certain double tax treaties.

Like other registered investment companies, a SICAFI is subject to an annual franchise tax, currently equal to 0.06 per cent of its asset value (such tax is scheduled to increase to 0.07 per cent in 2005 and to 0.08 per cent in 2007).

A SICAFI must also pay an annual fee to the BFIC equal to the sum of: (i) 0.0075 per cent of the net assets of the SICAFI as of the end of the preceding calendar year; and (ii) 0.075 per cent of the gross amount of shares of the SICAFI issued in Belgium during the preceding year.

#### **CONVERSION**

Due to the SICAFI's essentially exempt status insofar as Belgian income tax is concerned, special measures were also taken to prevent existing private real estate companies from converting tax-free to SICAFIs in order to avoid paying capital gains tax on appreciated real estate assets. Thus, the conversion of an existing real estate company into a SICAFI is assimilated for income tax purposes to a corporate liquidation and gives rise to an 'exit tax' of 19.5 per cent, applicable to any latent capital gains on the company's real estate assets (ie, measured as the difference between the market value of such assets and their tax basis in the hands of the real estate company). A further 10 per cent withholding tax is then imposed on the company's net asset value following payment of the foregoing tax.

## EVOLUTION OF SICAFI S

Following the adoption of the SICAFI regime, a number of large Belgian real estate developers either created SICAFIs or transferred assets to existing SICAFIs by way of sale or merger.<sup>3</sup> Approximately a dozen SICAFIs are currently listed on the Belgian stock exchange, with aggregate assets of nearly €5bn. Their portfolios fall into four general categories: office buildings, retail properties, semi-industrial properties (warehouses) and residential properties. The largest SICAFIs are active in the office building sector and have portfolios ranging from €260m to €1.8bn. In most cases, the SICAFI's sponsor or related companies hold a sizeable portion of the outstanding shares and the 'free float' ranges from 30 per cent to 80 per cent of the total share capital. The level of indebtedness varies from 14 per cent to 49 per cent of total assets, the weighted average indebtedness of all SICAFIs being approximately 41 per cent. Over the past several years, the average net dividend of all SICAFIs has been in the range of 6 per cent and total annual return on investment has been in the range of 15 per cent to 20 per cent. SICAFIs have thus substantially outperformed the Belgian stock market. A number of SICAFIs are currently trading at substantial premiums above their net asset value, although others trade at a slight discount off their net asset value. In less than ten years of existence, SICAFIs have established themselves as the investment vehicle of choice for private investors wishing to invest in a diversified portfolio of real estate assets. Although the general robust performance of the Belgian real estate market has contributed to this success, the liquidity, tax efficiency and general prudential supervision of SICAFIs by the BFIC are also key factors which have encouraged the relatively high level of investment in SICAFIs.

## LUXEMBOURG

Luxembourg has long been recognised as an attractive jurisdiction for the setting up of real estate investment vehicles. Over recent years, primarily as a result of stock market growths, Luxembourg's real estate investment funds have benefited from an increasing popularity, and this is expected to continue. At the end of 2003, 13 regulated real investment funds were registered in Luxembourg, comprising seven retail funds and six institutional funds, with an aggregate net asset value of €2.86bn representing 0.30 per cent of the total net asset value of all Luxembourg regulated investment funds.

The funds may be classified into two main categories of real estate investment funds: public and private. Both types of funds have separate target investors and consequently the regulations in respect of each are different.

## **PUBLIC FUNDS**

These consist of regulated real estate investment funds (ie funds which are undertakings for collective investment ('UCIs')) and which need to be approved and supervised by the Luxembourg regulators.<sup>4</sup>

Within this category are: (1) unit trust type funds, ie the 'Fonds Commun de Placement' ('FCPs') (which can be open- or closed-ended); and (2) company type funds, ie the SICAF which is a closed-ended fund and the SICAV which is an open-ended fund.

The principal object of UCIs is the investment in real estate. For this purpose, the term 'real estate' comprises:

- property consisting of land and buildings registered in the name of the UCI;
- shareholdings in real estate companies (including claims on such companies) the exclusive object and purpose of which is the acquisition, promotion and sale as well as the letting and agricultural lease of property, provided that these shareholdings must be at least as liquid as the property rights held directly by the UCI;
- property related long-term rights such as surface ownership, leasehold and options on real estate investments.

UCIs face a number of restrictions:

- in order to achieve a minimum spread of the investment risks, UCIs may not invest more than 20 per cent of their net assets in a single property, such restriction being effective at the date of acquisition of the relevant property. Property whose economic viability is linked to another property is not considered a separate item of property for this purpose. This 20 per cent rule does not apply during a start-up period which may not extend beyond four years after the closing date of the initial subscription period;

- should the investors have the right to redeem their shares, the UCI may provide for certain restrictions on this right. These restrictions must be clearly and precisely described in the offering prospectus;
- the aggregate of all borrowings of the UCI may not exceed in average 50 per cent of the valuation of all its properties; and
- at the end of the financial year, management must instruct the property valuer(s) to examine the valuation of all properties owned by the UCI or by its affiliated real estate companies. These UCIs pay an annual subscription tax ('taxe d'abonnement') of 0.05 per cent of their net asset value, which is reduced to 0.01 per cent for institutional funds/subfunds/classes.

## **PRIVATE FUNDS**

These consist of Luxembourg real estate companies, which are not governed by the legislation on UCIs, but by the general company law. Unlike UCIs, their target investors are types of joint venture, whereby the participants enter into private contracts. Consequently they do not face the same restriction or regulation as a UCI.

These companies either purchase real estate directly or, for tax reasons, indirectly through subsidiaries. These companies are fully taxable entities, although dividends received from subsidiaries and capital gains on the participations held in such subsidiaries may under certain conditions be exempt in Luxembourg under the 'participation exemption'.

## **PIF – WHAT VEHICLE SHOULD THE UK ADOPT?**

From the analysis of REITS across Europe and in the US, it is submitted that consultation should bring a PIF which has a combination of the following:

- a safe, tax-efficient environment for people to invest in commercial and residential real estate in a way which is less risky than buying a single residential real estate on a buy-to-let basis. This will reduce volatility in the commercial and residential real estate sector and will meet the government's aim of reducing the sector's exposure to debt and interest rate cycles;
- no restriction on external or internal management. Although the US experience has shown that those REITS which are internally managed are the best performers and internal management

clearly helps align the interest of management and investors, PIFs should not be prohibited from being externally managed;

- shares which are liquid and freely tradable. The majority of REIT shares can be purchased on major stock exchanges, and orders can be placed through stockbrokers. Financial planners and investment advisers can help to match an investor's objectives with individual REIT investment;
- no personal liability for investors;
- a structure which allows taxable income to be passed through rather than being independently taxed;
- accessibility. Both US and non-US sources invest in US REITs which are owned by thousands of individuals, as well as large institutional investors, including pension funds, endowment funds, insurance companies, bank trust departments and mutual funds. However, the French experience has shown that, in respect of SIICs, the biggest gains have gone to property companies, the state and foreign real estate investors and not to domestic investors or the French public. This may be a warning to the UK;
- an attractive rate of return. Dividends should not be so high that they prevent development or refurbishments of properties or subsidies for low rents;
- a free market approach to restricting the PIF's development activities. No restrictions on development would certainly help PIFs play a role in urban regeneration and assist the government's much wider post-*Barker* approach to affordable/social housing. It is notable that the property industry, post consultation, has highlighted this area as one of the major concerns for the success of PIFs;
- a free market approach to gearing and leveraging. In this article, we have seen that some jurisdictions, for example Belgium, restrict gearing where the SICAFI is based on a regulated investment vehicle, whilst other major economies, such as the US and France do not restrict gearing or leveraging, although in practice the market typically appears to gear up to 50 per cent of asset value. In the US for geared REITs, interest on debt is a deductible expense, but principal amortisation is not; this imposes a practical limit on gearing. On the question of how much borrowing should be allowed, the Treasury appears to favour a low level of borrowing in order to

increase scrutiny and market stability. However, a note of caution should be sounded, as with debt currently at a cost which is extremely low, it could prove an expensive way of raising finance to force a PIF to turn to the capital markets for funding for each proposed activity. Indeed if the Treasury 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. Further, debt finance need not be costly. With a credit facility the debt servicing costs are disclosed up front and, through hedging instruments, can remain the same throughout the term of the facility. Also, when considering vehicles which are complementary to PIFs, such as CP185 funds, in respect of retail investors, new tax rules allow authorised property unit trusts to gear up to 100 per cent of gross asset value and up to 50 per cent of the fund can be in development. As it is important that PIFs can compete if they are to be successful, from the analysis of REITS across Europe and in the US, it is submitted that the UK should not attempt to restrict the gearing on PIFs, but instead allow a market approach to gearing levels. The US model provides the form of investor scrutiny required by HM Treasury as the REITS there have to issue capital and then the analysts decide if it is a good or bad deal;

- a portfolio as diverse as possible providing a wide but straightforward choice for investors wishing to invest in an onshore regulated property investment vehicle. This may in turn lead to a lowering of the cost of capital, and provide a reliable source of capital to buy real estate, so enabling the developer to recover its invested capital and take out its entrepreneurial profit, which in turn may spur **development**<sup>5</sup> and lead to a more stable and efficient real estate market. Although this does raise a concern as to whether the small investor, ie the public, is ready for such a vehicle. The small investor should ideally be educated as to what a PIF investment entails, and thus its risks;
- a fair conversion charge. The Treasury appears to be adamant on a tax-neutral position. Any entry or exit level conversion charge must serve its purpose and should not prohibit the conversion of property-owning vehicles which may wish to convert to PIF status. A charge set too high could easily discourage conversion and not raise any money for the Inland Revenue. One-off stamp duty charges based on a percentage of net asset value have been proposed, as have exit charges based on CGT liabilities (following SIICs in France and SICAFIs in Belgium). However,

the trouble with CGT exit charges is that most UK companies have low CGT liabilities and so this would not favour the tax-neutral position;

- the ability to encourage investment by non-UK residents: at present, non-UK resident investing direct in UK property can receive their income gross and are exempt from capital gains tax on the disposal of UK property.<sup>6</sup> It is submitted that non-UK residents investing in a PIF should also be treated in the same way as if the non-UK residents were investing direct in UK property and thus able to receive their income gross. The Treasury is not yet convinced of this, and has asked for suggestions as to how the concepts inherent in the non-resident landlords' scheme could be satisfactorily adapted to investment made in PIFs by non-UK residents. The proposal to treat potential distributions of realised capital gains of non-UK residents taxable in the same way as income distributions may act as a disincentive for non-UK residents to invest in a PIF. Introducing a system of sourcing rules to establish the factual composition of distributions to distinguish between distributions arising from capital gains and distributions arising from income should not be dismissed by the Treasury as 'too complex'.

### **PUBLIC VERSUS PRIVATE?**

The consultation paper envisages that a PIF would be listed on the Stock Exchange to ensure the widest possible access for small investors to operate in a well-regulated environment. The Treasury highlights the greater regulatory regime that applies to listed companies. However, the take up of investment in approved investment trust companies is not great and it is submitted that this would be a mistake. It is clear that there are both advantages and disadvantages to being listed. Clearly there are advantages for investors if their units can be traded on a recognised exchange; similarly there is also room for private REITs, as we have seen from the successful private REIT market in the US. Thus a PIF should be capable of being listed but should not have to be.

### **EMPEROR'S NEW CLOTHES?**

The consultation paper has raised a number of important questions which require answering. The form that a PIF should take (including its name, although on a personal level what was wrong with REITs or Realty Investment Funds ('RIFs')) is now in the hands of those that respond to the consultation, the Treasury and the Inland Revenue. It should be remembered, however, that we have

been down this road before. For example, during the last housing boom, the government of the day extended the reliefs available in the Business Expansion Scheme ('BES'), which were originally intended to help small businesses, to include private landlords. Tellingly, the scheme was described in 1993 by the then shadow Chancellor, Gordon Brown, as 'a tax avoidance opportunity for top-rate taxpayers and the banking establishment'. It was shut down soon after. The next attempt to boost private renting, the Housing Investment Trust ('HIT'), went to the other extreme. HITs were launched in 1995, but had so many limitations and restrictions, that running a HIT was virtually impossible and, accordingly, the market ignored the scheme. If PIFs are confined to the residential market (which, given the scope of the consultation paper, is looking increasingly unlikely), or face too great a restriction on the development projects they can undertake, or are forced to have an element of residential stock in their portfolio, then it is more than likely that they will go the way of the BES and HITs.

The government though seem determined not to make these same mistakes. A key feature of a PIF is to prevent this exercise being wasted and once again to attempt to align the after-tax returns from holding real estate indirectly with those obtained from holding property directly. Given this incentive, the consultation paper and process is both vital and timely, if we are to follow the examples of the countries set out in this article and introduce a UK REIT (there I said it, much better than PIF) which will succeed and ultimately benefit the UK economy.

\* Andrew Petersen is Counsel specialising in cross border acquisition and real estate financing and corporate restructuring in the banking department of the London office of Dechert LLP. He is grateful to his international colleagues: Michael Hirschfeld, Nadine Young, Richard J Temko, Jean -Pierre Magremane, Marc Seimetz, Pascal Bouvy, Joseph Smallhoover and Oliver Platt for their respective contributions and his colleagues in London: Mark Stapleton and Ciaran Carvahlo for their comments.

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](http://www.hm-treasury.gov.uk/budget/budget_04/associated_documents/bud_bud04_adproperty.cfm)

- 3 Given the substantial real estate transfer tax applicable in Belgium, contribution of existing real estate to a SICAFI by way of merger or capital contribution in kind is a particularly attractive route since it generally enables the parties to avoid such tax on the transfer of the property to the SICAFI.
- 4 Law of 19 July 1991 (institutional funds) or by part II of the Law of 20 December 2002 (retail funds).
- 5 Analysts at Citigroup Smith Barney believe that the UK real estate sector's market capitalisation could double to £40bn if the regime changes. This is on the assumption that PIFs will be able to invest in both the residential and the commercial real estate markets.
- 6 Unless the disposal falls within scope of s 10 or 10a of the Taxation of Chargeable Gains Act 1992.