



HM TREASURY



Inland
Revenue

Promoting more flexible investment in property: a consultation

March 2004

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FOREWORD BY RUTH KELLY, MP

A healthy and stable property market is a key element in any successful economy. In the residential market this is of crucial importance to individuals, not only as a place to live, but also as a form of long-term security and savings. Commercial property represents a major factor of production for almost all sectors of the economy but over recent decades the UK property market has been a source of destabilising cycles – too often a barrier to growth and productivity.

As we address the underlying causes of instability and the barriers to growth, this Government is determined to look at the fundamental reforms necessary to improve the workings of the property market, address the unresponsive supply of housing, and reduce inefficiencies in the market for commercial property.

In particular, in April 2003 the Chancellor asked Kate Barker, a member of the Bank of England's Monetary Policy Committee, to report on measures to improve the supply side of the housing market. Her interim report¹ published alongside the 2003 Pre-Budget Report, recommended "...there is merit in the Government considering a vehicle, based on the US Real Estate Investment Trust model, to encourage increased institutional investment."

The Chancellor and I welcomed that proposal and this consultation document now implements the recommendation – extending its scope to cover commercial, as well as residential property investment. This consultation will therefore explore the scope for a wide-ranging reform of the tax treatment of property investment; to expand investment opportunities, encourage flexibility, reduce risk and promote effective property management, while continuing to raise a fair amount of revenue from the sector.

The Government is grateful for the analysis that the property industry and others have already provided on this subject, which has demonstrated their willingness to rise to the challenge of reform in a manner which creates the potential to have real benefit for business and individuals. In keeping with our commitment to consult on tax reforms wherever possible, we invite the widest possible range of views on these proposals and encourage all those with a stake in the property investment market to consider the issues in depth.

Ruth Kelly, MP

Financial Secretary to the Treasury

¹ Review of Housing Supply: Securing our Future Housing Needs (Interim Report) by Kate Barker, December 2003. (www.barkerreview.org.uk)

ABOUT THIS CONSULTATION

Timetable for responses

The Government welcomes responses to the issues and questions raised in this document by 16 July 2004. A summary of questions is provided in Annex A. In submitting responses, where possible, please provide analysis and evidence to support the views expressed.

Responses should be submitted by email to:

PIFconsultation@hm-treasury.gsi.gov.uk

Postal responses and any questions relating to this document should be addressed to:

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1 Horse Guards Road
London SW1A 2HQ

Tel: 020 7270 4916

Email: PIFconsultation@hm-treasury.gsi.gov.uk

When responding please state if you are responding in an individual capacity. If you are responding on behalf of an organisation please state who the organisation represents and how the views of members were assembled.

Your response may be made public. If you do not want all or part of your response or name made public, please state this clearly in the response. If you do not request specific confidentiality, this will override any confidentiality disclaimer that may be generated by your organisation's IT system.

Other details

You may wish to refer to the Cabinet Office website for the Government's Code of Practice for written consultations: www.cabinet-office.gov.uk

A partial regulatory impact assessment is published in Annex B of this document.

If you have technical tax questions relating to this document, contact:

Inland Revenue Business Tax Policy

Tel: 020 7438 7426

THE ECONOMIC CONTEXT

This consultation document seeks views on how a new vehicle for investing in property might be structured in order to meet the Government's objectives to encourage an efficient and flexible property investment market, with fairness for all taxpayers.

Chapter 1 provides the economic context of the commercial and residential property markets, and sets out the case for tax reform, along with the Government's objectives.

1.1 The 2003 Pre-Budget Report¹ announced that “in line with the interim recommendations of the Barker Review², the Government has concluded that reform to the tax treatment of property investment would improve liquidity, transparency and scrutiny, provide access to property for long-term savings, and could expand the private rented sector.”

1.2 This document launches the consultation on how the legal and tax structure of a new vehicle might be developed in order to meet the Government's objectives, alongside related property investment products. It responds to concerns that barriers in the tax system may be contributing to distortions in the market for property investment resulting in poor liquidity, barriers for smaller investors entering the market and high debt financing levels, all of which may be hindering progress towards a more stable and efficient market, better able to support the Government's economic objectives. It draws on the experience of a number of other countries, where the introduction of bespoke vehicles has played an important role for savings and investment in property.

1.3 For the convenience of this document such a vehicle for the UK is referred to as a “Property Investment Fund” (PIF). This name may change to reflect the final structure, and the Government would welcome alternative suggestions. A key feature of a PIF would be to align the after-tax returns from holding property indirectly more closely with those obtained from holding property directly.

1.4 The intention is not to reduce the tax contribution made by the property investment market, but to reform the means by which it is made and therefore deliver a more efficient market, making a stronger contribution to growth and productivity. Therefore, in line with conclusions published in the 2003 Pre-Budget Report, this consultation document also seeks views on the most appropriate way to allow those wishing to convert existing property investments into a new PIF. In order to protect the Exchequer against loss of revenue it is envisaged that a conversion charge would be applied.

¹ Pre-Budget Report: ‘The strength to take the long-term decision for Britain’ December 2003, HM Treasury (Cm6042)

² In April 2003 the Chancellor asked Kate Barker, a member of the Bank of England's Monetary Policy Committee, to undertake a review of housing supply in the UK. The interim report ‘Review of Housing Supply: Securing our Future Housing Needs’ was published in December 2003. (www.barkerreview.org.uk)

International comparison of specialist property investment vehicles

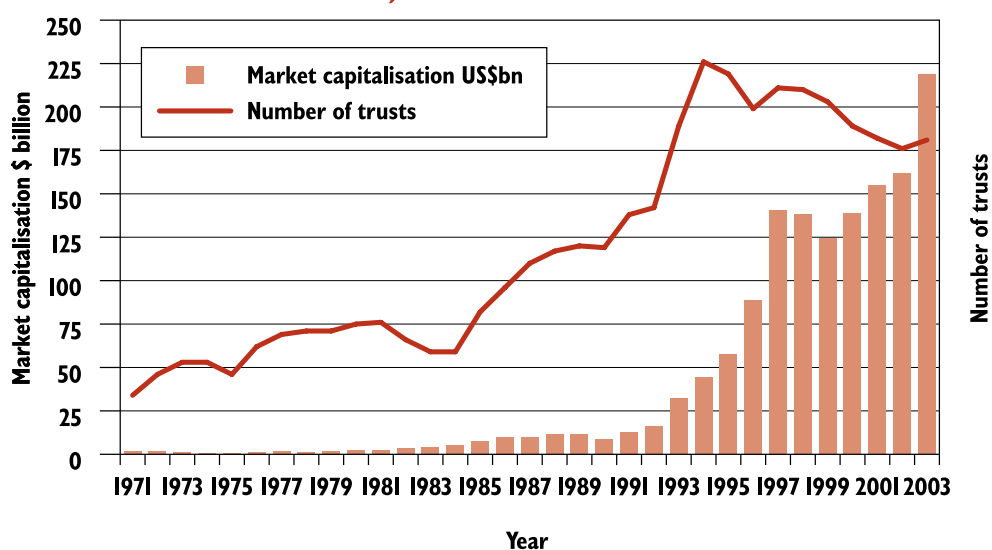
Many of the leading global economies currently operate a bespoke property investment vehicle. The exact structure varies, although the main principle applies – that the returns from indirect investment broadly reflect the returns from the underlying asset (property). This is commonly achieved through a vehicle that pays no tax at the corporate level, and is instead required to distribute a high level of its income and capital to investors, where tax is then collected.

While the Government intends to create a Property Investment Fund (PIF) that meets the particular characteristics and needs of the UK property market, it is useful to draw on the experiences of other countries. Chapter 2 discusses in more detail a cross-country comparison of the key features and requirements of property investment vehicles.

The longest standing markets in the world are the US Real Estate Investment Trust (REIT) market and the Australian Limited Property Trust (LPT) market.

In the US, while some developers remain as regular tax paying companies there are now few property companies who are not structured as a REIT. Chart I.1 below shows the increase in size of the US REIT market between 1970 and 2003 – measured by market capitalisation, which increased to over US \$200 billion by 2003, and the number of REIT funds, which now exceeds 175. Most of these funds are dedicated to real estate investment.

Chart I.1: Market capitalisation and number of trusts in the US REIT market, 1971 to 2003



The Australian LPT market began in the 1970s but took off from the early 1990s – current market capitalisation is around AUS \$45 billion. The Australian LPT market has emerged in two tiers, with passive rental income assets held in a LPT structure and property development held in a company structure subject to normal corporate tax rules. Australian LPTs tend to be internally managed and many are involved in urban renewal projects.

There has also been a growth in recent years in the Far East with the rapid growth of the Japanese J-REIT market, and also in Hong Kong and Singapore.

PROPERTY IN THE UK ECONOMY

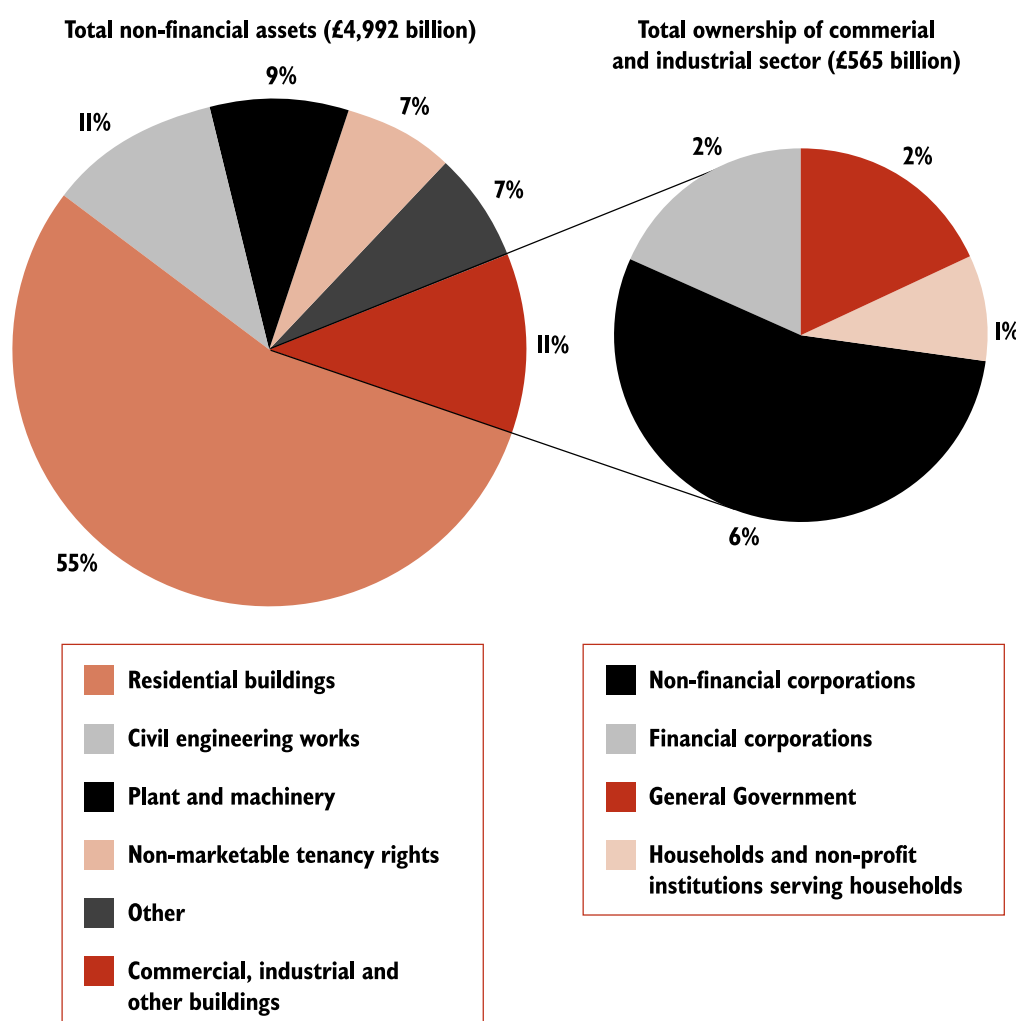
1.5 Property, in both the commercial and residential sectors, makes a significant contribution to the UK economy. The 2003 UK National Accounts 'Blue Book', published by the Office for National Statistics, shows that in 2002 the two sectors combined represented around two-thirds of total non-financial assets on the national balance sheet.

The commercial sector

1.6 Commercial property in the UK acts as both a factor of production, and as an investment opportunity. Owners of commercial property include both institutional investors as well as owner-occupiers.

1.7 Chart 1.2 shows that in 2002 the total stock of commercial property assets held on balance sheets amounted to £565 billion, held largely by the public sector, and by non-financial corporations.

Chart 1.2: Total Non-Financial Assets in the UK National Accounts, showing commercial and industrial buildings by owner type



Source: UK National Accounts, The Blue Book 2003, Office for National Statistics

1.8 The investment market for property accounts for an estimated £250 billion of this total stock, held by a range of bodies, including large financial institutions, property companies (either listed on the Stock Exchange or in the private market), limited partnerships and private investors, based either in the UK or overseas.

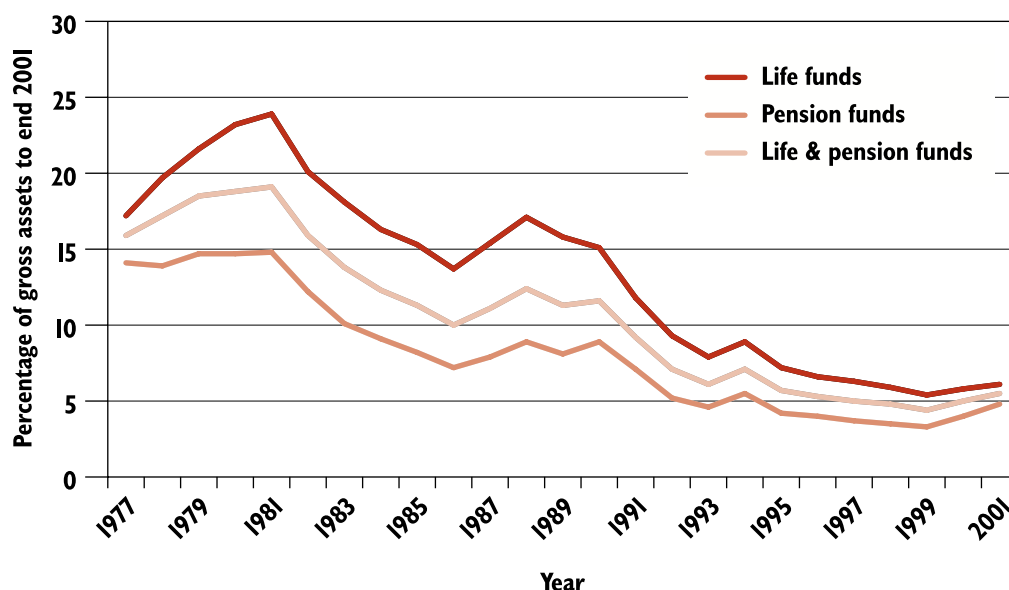
1.9 A number of features can be observed from the UK commercial property market in recent years:

- Chart 1.3 shows that office occupancy costs in London are the highest in the world, and rents in UK cities outside London are also high in comparison with major cities elsewhere. While this partly reflects the attractiveness for business to locate in the UK, a more efficient market should result in more competitive pricing;



- since the 1980s, despite the attractive risk-adjusted returns and good diversification characteristics from property, large institutions such as pension funds and insurance companies have reduced the share of property held in their portfolio of assets, opting instead to invest more of their funds in equities. Chart 1.4 shows this pattern, although the trend has reversed somewhat in recent years as the returns from equities have fallen. It should also be noted that while the proportion of property held has fallen, the absolute value of property assets has risen substantially;

Chart I.4: Institutional investment in property in the UK, 1977-2001

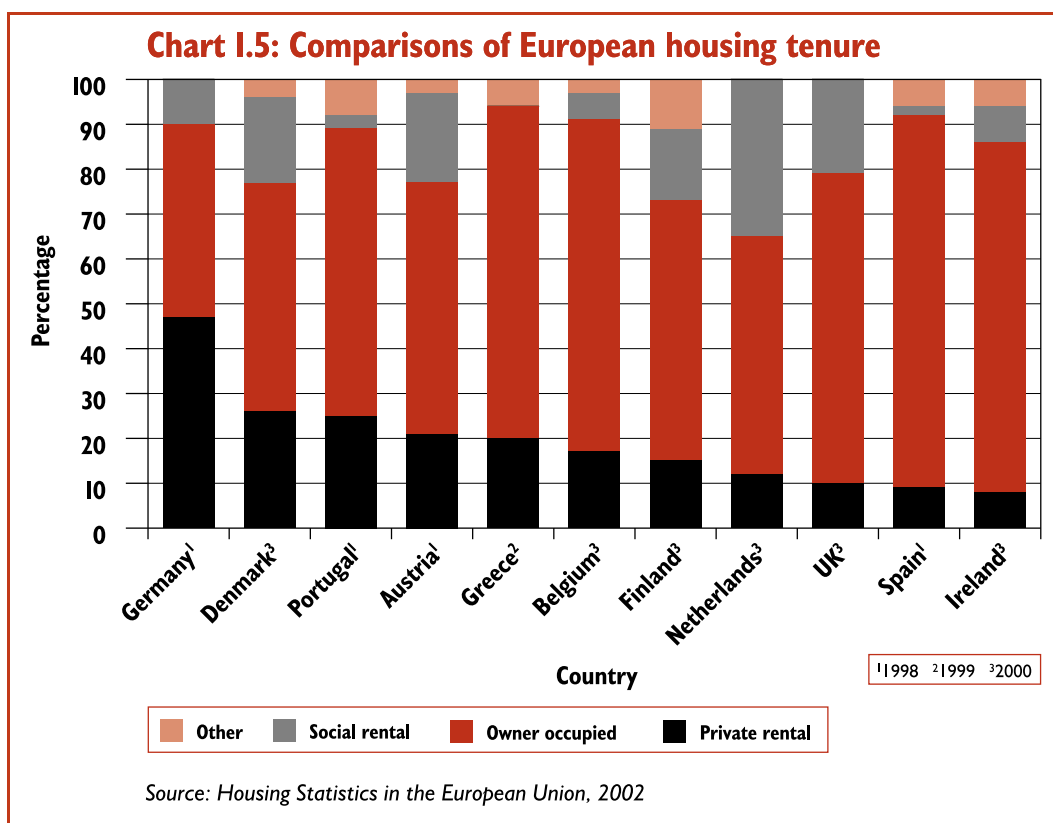


Source: British Property Federation, Investment Property Forum and Royal Institute of Chartered Surveyors

- there has also been a decline in the publicly listed property sector as companies have opted for private ownership, where they can potentially achieve higher returns through higher borrowing. Many quoted property companies trade at a discount to net asset value, which makes it hard to raise new capital. The tax liabilities associated with indirect investment – compared with the tax treatment of direct property investment – is one factor behind this trend; and
- investment in UK property has also been re-directed through other tax efficient structures. Limited partnerships for example have increased significantly in value from around £2 billion in 1997 to around £15 billion by 2002. The number has also increased with over 100 UK limited partnerships specialising in property by 2002.

The residential sector

1.10 The UK residential housing market is dominated by the owner-occupied sector, meaning that housing is a key asset for the majority of households. While the private rented sector provides a flexible form of housing that contributes to labour market mobility, its 10 per cent share of the market is low in comparison to the US and many European countries. Chart 1.5 shows the tenure split between owner-occupied, private rented and social rented housing across 11 European countries.



1.11 Strong price rises in the UK in recent years have encouraged investment in residential property and the private rented sector, with a big expansion in the buy-to-let market. However institutional investment in the sector is still low, and over 70 per cent of the private rented stock is run by landlords managing only a few properties. There is significant variation in the quality of both management and property with the bottom end of the market having some of the lowest quality housing stock.

1.12 Part of the overall findings of the Barker Review interim report², published in December 2003, recommended “...there is merit in the Government considering a vehicle, based on the US Real Estate Investment Trust model, to encourage increased institutional investment.” The Government has accepted this recommendation and is now consulting to establish the most suitable structure.

1.13 The US Real Estate Investment Trust (REIT) market provides an example of the success of more institutional investment breaking into the residential market. For the UK this could allow more efficient management, greater renewal and preservation of property, and a more liquid supply of housing. This in turn should help to promote greater labour market mobility for the UK economy and address problems of the provision of affordable housing, including for key workers in areas of high house prices.

1.14 This potential in the UK for greater corporate and institutional investment in the private rented sector should also raise standards and provide an alternative to the highly geared buy-to-let market. A PIF structure in the UK would therefore set a challenge for the industry to encourage development of new housing, which could ultimately be managed within a PIF.

THE CASE FOR TAX REFORM

1.15 The above trends in both the commercial and residential property investment markets may be simply a reflection of market forces. However the Government believes there are a number of features of the market that are resulting in it operating inefficiently, thereby reducing the full potential for productivity growth for the UK economy. These inefficiencies can be summarised as:

- **lack of choice for small investors** – who tend to access property in higher risk ways, such as buy-to-let investments or direct ownership, and therefore cannot diversify their portfolio to reduce risk;
- **poor liquidity** – which is a reflection of the nature of property itself as an asset. The commercial property market is dominated by large investors and pricing and investment decisions are largely determined by individual transactions among a small number of players;
- **potential for more efficient use of property** – a high proportion of commercial property in the UK is owner-occupied, and this tends to be used less intensively than property in the investment market. More indirect investment may allow increased efficiency through economies of scale;
- **high levels of debt financing** – which increase the sector's sensitivity to interest rate changes, coupled with lower transparency and scrutiny in the private sector, may lead to instability in the wider economy;
- **tax distortions** – as investors are taxed differently depending on how they invest in property, it is not easy to compare performance of different investment choices. This may result in investors undertaking more risky, less suitable investments than if it were possible to make a simple and direct comparison; and
- **variable standards of provision in the private rented sector** – with the lowest quality housing stock and management at the bottom end of the market. Improvements and expansion to this sector could enhance efficiency and flexibility in the housing market.

1.16 The Government believes that tax reform could help to address many of the inefficiencies that currently impact on the property investment market. A more efficient market should contribute to the long-term objective of raising the level of productivity and economic growth in the UK, as well as being consistent with the Government's objective of promoting savings.

1.17 This consultation document considers the most appropriate structure for the creation of a PIF. The broad principle is to consider a savings and investment vehicle that would provide a liquid market in property investment that is widely accessible by the private investor. Such a vehicle would need to fit alongside existing savings opportunities, and should be designed to enable investors to have clarity in the tax treatment of alternative vehicles.

1.18 One option for achieving this might be to construct a new bespoke vehicle with a tax treatment more closely aligned to the tax arrangements in place for direct investment in property. As such, a PIF might be designed in a way that it pays no corporation tax. Instead the PIF would be required to distribute a high level of income

to investors, and tax would be collected from individual investors on the returns they receive from the PIF.

1.19 The requirement to distribute a high level of income emphasises the crucial distinction between an investment vehicle that provides returns to investors from managing and leasing property, and a normal trading company that would need to re-invest a significant proportion of profits and so naturally falls within the normal corporation tax rules.

1.20 Property is unique in comparison with other assets since it is both a factor of production, and an investment opportunity in its own right. This does not apply to other sectors and assets where, for example, plant and machinery on their own do not represent individual investment opportunities. Their main value is the part they play in the production process.

1.21 A PIF structure with a high income distribution requirement might therefore not suit a company seeking to develop new property itself, but would provide a vehicle in to which newly developed property could be sold and managed, providing a product for individuals to invest in.

POLICY OBJECTIVES

1.22 There are a number of objectives against which a PIF structure will be assessed. Any new structure should:

- improve the quality and quantity of finance for investment in both commercial and residential property in a manner that promotes economic stability and market flexibility and helps to increase the supply of property;
- expand access to a wider range of savings products on a stable and well regulated basis, and therefore promote long-term savings for individual investors;
- protect all taxpayers by ensuring that a fair level of taxation continues to be paid by the property sector, and reduce opportunities for tax avoidance; and
- support structural change in property markets to reduce the costs and improve the quality and flexibility of commercial property to business users, and to improve efficiency, affordability and professionalism in the private rented sector for residential tenants.

Question for consultation:

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.

2

POSSIBLE STRUCTURES FOR A PROPERTY INVESTMENT FUND

Chapter 2 looks in detail at possible models for a Property Investment Fund. It examines the relationship to other investment vehicles and the restrictions that may be required to qualify for PIF status that justifies different corporation tax treatment.

2.1 The Government intends to ensure the greatest amount of market freedom consistent with meeting the objectives outlined at paragraph 1.22. However it also believes that there should be certain additional responsibilities to meet, as a condition for becoming a PIF, and to qualify for different corporation tax treatment. It may therefore be appropriate to impose some restrictions on market freedom.

2.2 It is anticipated that should a PIF exceed any of the operational parameters, it would revert to being fully taxable as if it were a company subject to corporation tax. The Government welcomes overall comments on the degree to which restrictions are necessary in order to achieve the objectives set out in paragraph 1.22 – specific questions are set out during this chapter.

2.3 Preliminary research by reference to international experience shows that property investment vehicles that have worked well are closed-ended, publicly listed and internally managed. Table 2.1 provides a cross-country comparison of the main features of property investment vehicles around the world.

Table 2.1: Cross-country comparison of property investment vehicles

Country	Date created	Minimum income distribution* (per cent)	Limit on gearing	Development allowed?	Minimum investment in property (per cent)
US	1960	90	No limit	Yes	75
Netherlands	1970	100	60	Restricted	100
Australia	1971	100	No limit	Yes	50 **
Belgium	1990	80	50	Restricted	100 **
Canada	1994	85-100	50	Restricted	95
Singapore	1999	100	35	Restricted	70
Japan	2000	90	No limit	Restricted	75
France	2003	85	No limit	Yes	100 **
Hong Kong	2004	90	35	Prohibited	100

Source: UBS and HM Treasury

* All are after depreciation except Singapore ** The main activity must be from passive rental income (this is a condition for entry into the Australian LPT index not a regulatory requirement)

2.4 The common theme to emerge from this analysis is that in many of the countries where such property investment vehicles operate there is a requirement to distribute a high level of income to investors, combined with restrictions on the gearing and development activity permitted.

2.5 There may also be alternative structures that meet the needs of small investors looking to diversify their savings into property. For example, an open-ended vehicle regulated by the Financial Services Authority (FSA), such as an Authorised Unit Trust (AUT) or Open-Ended Investment Company (OEIC), could also work. Such vehicles have a requirement to distribute high levels of income and are able to offer a spread of investments, which includes property.

2.6 In evaluating responses to this consultation document, the Government seeks views on the likely impact of alternative structures on the various sections of the property market, on the impact on different types of investors, and the extent to which behavioural change might occur.

STRUCTURAL FEATURES OF A PIF

2.7 This section looks at some of the structural features specific to the design of a PIF.

Stock Exchange listing

2.8 One of the objectives of introducing a new PIF is to expand the opportunity for small investors to invest in a wider range of property. To achieve this it is envisaged that a PIF would be listed on the Stock Exchange to ensure the widest possible access for small investors. This requirement would prevent privately held property companies in their current form from being able to take advantage of any special tax arrangements that might be available to a PIF without delivering some of the wider public benefits.

2.9 The UK already has listed vehicles that offer pooled investment in a portfolio of assets – approved Investment Trust companies (ITCs). To be approved these are required to be listed on the Stock Exchange. This ensures a wide investor base and encourages access to the retail investor. However, even though ITCs have existed for a long time, they do not attract the same level of interest from small investors as their unlisted equivalents, AUTs and OEICs.

2.10 An advantage put forward for a listed company structure is that there is more frequent market scrutiny, for example every time additional capital is required a prospectus is produced giving full details. Such companies also have to follow the rules and requirements of listing together with other regulatory rules that apply. Combined with a high distribution requirement, there would be limited scope for a PIF to invest out of retained profits, which would mean that capital would have to be raised by a new request from the market. This framework might help to ensure a higher level of market scrutiny, although it might have some associated administrative costs. In addition, a listed structure might provide greater liquidity in the market than alternative vehicles.

2.11 Another potential advantage is that a listed PIF might trade closer to its net asset value, making it easier to raise new capital in the market. Closing the gap to net asset value would however be crucial to the success of a listed structure. If this were not achieved, then a listed PIF might have no more access to capital than existing property companies.

2.12 The objective of a wide investor base may also be achieved through the existing well developed collective investment schemes. Although these schemes (AUTs and OEICs) are not publicly listed in the way companies are, they do publish on a regular

basis the spread price at which units may be bought and sold. They also have an obligation to redeem units on demand, so investors are able to gain ready access to their money. In addition, net asset values are determined on a regular basis, and this is governed by regulatory guidelines, rather than market sentiment.

2.13 An advantage of a structure and regulatory regime similar to AUTs and OEICs is that it is already a well-established product, familiar to small investors. A disadvantage is that these structures are open-ended, with the associated problems when investing in illiquid assets. This is described more fully in paragraph 2.15.

2.14 Under either option, it is envisaged that a PIF would be subject to the appropriate regulatory regime.

Closed-ended or open-ended

2.15 Property, particularly in the commercial sector is an illiquid asset and cannot be acquired or disposed of quickly. Significant funds are required to enter the market. Its illiquid nature is one of the reasons why existing AUTs and OEICs have been unable to invest 100 per cent of their assets in property. Had they done so, it would have been extremely difficult, if not impossible to redeem units regularly – this is a requirement for authorisation as a collective investment scheme. Depending on investor sentiment, an open-ended structure could mean that the scheme may have to liquidate its assets quickly at a time that might not be the most appropriate for the market, which can cause problems and lead to macro-economic instability.

2.16 The difficulties outlined above do not arise with a closed-ended structure. Investors withdraw their investment by selling shares in the vehicle. The price that is obtained reflects market sentiment, but does not require the company to sell assets. The discount from or premium to the underlying asset value is able to take the burden of adjustment rather than the asset base itself.

2.17 While the difficulties of redemption in an open-ended structure can be mitigated by limiting the occasions on which investors can redeem units, or by the fund holding cash reserves to allow for redemptions, this effectively results in a vehicle that has some closed-ended characteristics.

Investor base

2.18 Some of the issues surrounding the objectives of a wide investor base and enhanced liquidity in the property investment market have already been discussed above.

2.19 To ensure a wide investor base and liquidity in the market for shares, it may be necessary to require a minimum number of investors in a PIF. In addition the maximum concentration permitted to be held by an individual investor or a group of connected investors in a PIF could be restricted such that 20 or fewer people would hold no more than 49 per cent of the shares.

Question for consultation:

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?

Internally or externally managed **2.20** The debate here concerns the extent to which a PIF should also have day-to-day responsibility for managing the properties owned by the PIF. In some countries it is a requirement that property assets are managed internally, while in other countries the market is free to choose.

2.21 If a PIF invests in a diverse portfolio of property the management skills for, say, light industrial and office space might be different. By outsourcing the management of property, greater flexibility and access to a wider range of dedicated skills may be possible, thereby allowing greater efficiency and economies of scale. However this may bring conflicts of interest between different parties, as demonstrated by over-priced management fees. Investors may therefore prefer an internally managed structure as it aligns the investor's incentives more closely. Internal management may also allow more detailed knowledge of the specific location of tenants and buildings to be utilised.

2.22 In most countries where equivalent property investment vehicles exist, particularly the US and Dutch markets, internally managed structures have historically been more popular. The Australian model allows for both types of management, although investor sentiment is now also tending towards internal management after initially preferring external management.

Question for consultation:

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

Distribution requirements **2.23** A key feature that would accompany any relaxation of the corporation tax rules within a PIF would be a requirement to distribute a high level of income to investors. This would play a key role in determining the trading value of units or shares in a PIF. Essentially the value would be determined by reference to the income stream as much as by the balance sheet value of the underlying capital assets.

2.24 As highlighted in Table 2.1 earlier in this chapter, the requirement to distribute a high level of income to investors is a common feature among all countries operating similar property investment vehicles.

2.25 While this provides a clear steer for the overall principle for a UK PIF, the exact level of distributions should be designed to reflect conditions specific to the UK. If the requirement to distribute is set too high, it might be argued that there is insufficient cash retention to ensure that the property invested in is maintained to a high standard. On the other hand, if set too low, a PIF may be less attractive to investors, as it would not provide a robust cash flow. It would also defer tax receipts for the Exchequer.

2.26 There are other factors to consider in setting an appropriate level for distributions. One, referred to above for open-ended vehicles, is the possible need to retain cash to meet investor withdrawals. Others are linked to the scope of the functions of a PIF. For example, if a PIF were permitted to undertake significant regeneration projects then a high income distribution requirement would result in all additional capital having to be obtained through the capital markets. However this may be a good thing if it provides a mechanism for regular market scrutiny of the PIF.

2.27 A complication with comparing distribution levels in other countries is the extent to which depreciation is taken into account in arriving at the income from which distributions are to be made. Based on a comparison of other countries, a requirement to distribute at least 90 per cent of income (before depreciation) appears to strike a

balance between an attractive distribution policy, and maintaining sufficient working capital within the vehicle.

2.28 There may be further issues arising from the introduction of International Accounting Standards. For example if, for companies, unrealised capital gains are to be taken to the income statement, there may be concerns around the impact on distribution requirements set for a corporate PIF.

Question for consultation:

Should the minimum income distribution requirement be 90 per cent (before depreciation)?

Distribution of capital gains

2.29 While there is a reasonably common approach for requiring a high distribution of income, there are a range of options for the distribution of realised capital gains. How the vehicle and the investors are taxed is an important factor in how capital gains are distributed, and this aspect is considered in more detail in Chapter 3.

2.30 One of the advantages put forward for listed status earlier in this chapter was the regular scrutiny that would take place every time a PIF wanted to raise fresh capital. On this basis there is an argument that all realised capital gains should also be distributed immediately to investors, thereby encouraging a PIF to return to the market each time it wanted to raise new capital.

Borrowing levels

2.31 Borrowing levels range considerably in those countries that operate similar structures to a PIF. Table 2.1 shows that in the US REIT market there is no borrowing limit set by legislation, although in practice, the market appears to bear up to 50 per cent and in other countries a limit ranging from 35 per cent to 60 per cent of asset value is imposed by legislation. 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.

2.32 Some borrowing within a PIF may, however, be necessary to meet short term and unforeseen liabilities, and to buy and sell assets, without holding large cash reserves. The assumption however is that the main capital requirements of a PIF will be provided by investors (either as shares or units, depending on the nature of the vehicle), and that borrowing would only be needed as a contingency margin.

2.33 Such a margin might be achieved by a low percentage limit on the nominal share value or asset value. This would be consistent with a higher level of investor scrutiny, which would be achieved by requiring a PIF to raise new capital from the market, rather than seeking debt financing.

Question for consultation:

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

Investment restrictions

2.34 Consideration of this covers a number of issues; the extent to which a PIF should be able to undertake development activity itself, invest in non-property assets, the definition of what constitutes eligible property, the period of ownership of property assets, and other features of the commercial and residential property markets.

Development activity

2.35 The Government is keen to encourage greater renewal in the property sector, and the development of new commercial and residential buildings, while also ensuring that the property sector continues to contribute its share of tax. The latter objective points to requiring a high level of income and capital to be distributed by a PIF to investors.

2.36 In order to satisfy both the above objectives for development and fairness across all taxpayers, there are several options the Government could pursue. One option would be to legislate against development activity within a PIF, but encourage the use of a PIF as a vehicle into which previously developed property could be managed more efficiently. Alternatively the requirement for a high distribution level and borrowing restrictions might mean that a PIF is not well suited to development itself, but instead provides a vehicle into which newly developed property could be sold and then managed, allowing individual investors to obtain the rental returns. Another approach could involve charging tax on trading and development activity by the PIF, although this would bring administrative complexity for business and the Inland Revenue.

2.37 Consideration also needs to be given to whether a PIF should be permitted to invest in other PIFs, create subsidiaries, hold shares in other companies, or other sophisticated financial instruments. Other vehicles may be able to provide this kind of investment.

Definition of property

2.38 Assuming that investments held by PIFs are restricted to land and buildings, there are also issues around the definition of property permitted. The role of a PIF is intended to encourage greater indirect investment and more efficient management of property. Providing flexibility for both the investor and the occupier is a key objective.

2.39 To meet the stated objectives, and ensure fairness for all taxpayers, the Government believes that a PIF should only be able to invest in property types where the rental returns reflect the underlying property asset. Restrictions may therefore be necessary to allow only commercial, industrial, office and residential buildings. Under this definition, land and buildings that form part of a leisure trading company, such as a hotel or golf course would be excluded. It is also likely that specialist use property, such as hospitals and infrastructure projects, would be excluded.

2.40 Part of this definitional problem may be resolved by requiring a PIF to be listed, since it would require trading companies, such as hotels, to give up a significant part of their control over the property component of their business activity.

Question for consultation:

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.

Period of ownership of assets **2.41** One of the objectives for setting up a PIF would be to promote long-term investment in property, and to maintain over time a high quality stock of property. This suggests that there would be some merit in requiring a PIF to hold property for a minimum period of time in order to ensure better quality of stock. The trade-off with this is that a more flexible market, allowing regular turnover of properties and shorter periods of ownership, should, all other things equal contribute to greater efficiency and productivity in the economy.

Question for consultation:

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?

The wider agenda for reform

2.42 The Government is also interested in what other objectives could be pursued through the design of a PIF. In particular whether there is potential to require a PIF to meet certain criteria as a condition for different corporation tax treatment.

The private rented sector and social housing **2.43** The social housing and private rented sectors together account for around 30 per cent of the housing market – the remainder being in the owner-occupied sector. The Government believes there is great potential to increase corporate and institutional investment through a PIF, in order to raise standards in the rented sectors, and provide an alternative to the highly geared buy-to-let market. It is also keen for a PIF to stimulate greater development activity in the residential market providing a vehicle into which new properties can be converted and managed more efficiently.

2.44 The Government is keen that the industry rises to this challenge in the residential sector, and is open to considering how a PIF could be designed to encourage this. For example whether it would be practical to require a percentage of a PIF's investment to be in residential property.

Question for consultation:

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?

Flexibility of lease terms **2.45** The Government believes that there is potential for greater flexibility of lease terms in the commercial property market and is keen to explore how the design of a PIF could be structured to support this objective.

Question for consultation:

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