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UK PROPERTY AUTHORISED INVESTMENT FUNDS

From 6 April 2008, a new form of regulated tax-advantaged real property investment company with variable capital will become available in the UK, known as a "property authorised investment fund" (PAIF). It is modelled on existing rules for open-ended equity and bond authorised investment funds in the UK. A PAIF is a potentially more flexible and tax-efficient UK property investment vehicle than a closed-ended listed UK real estate investment trust (UK-REIT). The PAIF tax regime is outlined below, together with the main advantages and disadvantages of PAIFs compared with UK-REITs.

Overview of PAIF Regime

- A PAIF must be structured as an open-ended (i.e. variable capital) investment company (OEIC) incorporated in the UK.
- It has to be authorised and regulated by the UK Financial Services Authority (FSA).
- No requirement for a stock exchange listing (which is unnecessary for an OEIC as liquidity is provided to investors by the PAIF itself).
- May be used by retail, sophisticated and institutional investors in the UK and abroad.
- If certain conditions are met, and PAIF status is elected, its property investment income is tax exempt.
- All capital gains are also tax exempt.
- Income distributions to UK and foreign shareholders are, with some exceptions, subject to a UK withholding tax.

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- Special UK tax charges are imposed on a PAIF which carries excessive debt or pays distributions from exempt income to any company holding 10% or more than of its shares.
- A PAIF is generally entitled to the benefits of the UK's extensive double tax treaty network.

Conditions for PAIF Tax Status

- The OEIC must carry on a property investment business (PIB) which accounts for at least 60% of its net income and total asset value (40% in year 1). The PIB may consist of a property rental business in the UK or abroad (held directly or through a special purpose vehicle), shareholdings in UK-REITS and/or shareholdings in listed foreign equivalents of UK-REITS. Property development activities will not normally qualify as a PIB.
- PAIF shares must be widely available to a broad range of unconnected investors.
- The PAIF must take "reasonable steps" to ensure that no company acquires a beneficial interest of 10% or more in the net asset value of the PAIF, e.g. by means of divided strip, stock lending or repo arrangements.
- The PAIF may not incur any participating debt or debt on off-market terms.

Taxation of PAIF

- The PAIF is exempt from UK corporation tax on its net PIB income, dividends received from any UK company and all capital gains (whether or not arising in the PIB).
- Other forms of net income (in practice, mainly debt interest, derivative contract income and non-UK dividends) are subject to UK corporation tax at the special OEIC rate of 20%. (Distributions from such net income are treated as tax-deductible interest payments under the PAIF regime).
- Foreign tax credit relief is available in the normal way to a PAIF in respect of its taxable (non-PIB) foreign source income.
- If a PAIF is targeted (as a qualified investor scheme) only at professional investors and its PIB income is less than 1.25 times greater than PIB-related finance costs, the PAIF is liable to a special corporation tax charge at the rate of 20%.
- If the PAIF fails to take reasonable steps to prevent a dividend from PIB income being paid to a company which has a 10% or greater interest in its net assets, the PAIF is liable to a special corporation tax charge at the rate of 20%.

Withholding Taxes

- No withholding tax on:
 - (a) PIB income distributions paid by the PAIF to a UK taxable company, a UK charity or an exempt UK pension scheme;
 - (b) distributions paid by the PAIF out of its UK dividend income; and
 - (c) distributions paid by the PAIF out of any capital gains.
- 20% withholding tax on:
 - (a) PIB income distributions paid to other UK shareholders (e.g. individuals and trustees);
 - (b) PIB income distributions paid to non-UK shareholders (as reduced by any lower treaty rate of dividend withholding tax for portfolio shareholders); and
 - (c) distributions from taxable income paid to UK and foreign shareholders (as reduced by any lower treaty rate of dividend withholding tax to portfolio shareholders).

Taxation of PAIF Investors

- See above for UK withholding taxes applicable on PAIF distributions to UK and foreign investors.
- UK resident individuals are subject to income tax at normal rates on all types of PAIF distribution (with credit for any withholding tax).
- UK taxable companies are liable to corporation tax at normal rates on all types of PAIF distribution (with credit for any withholding tax), except for distributions from UK dividend income which are tax exempt.
- UK exempt investors such as pension funds and charities are tax exempt on all PAIF distributions received on investment account.

Comparison with UK-REITS

- As an OEIC (i.e. with variable capital), a PAIF (unlike a closed-ended UK-REIT) is not required to list its shares on a stock exchange.
- A UK-REIT must carry on a tax-exempt PIB which accounts for at least 75% of its net income and total asset value (compared to 60% for a PAIF whose larger pool of non-PIB assets provide the liquidity to enable it to redeem out its shares on regular dealing days).

- A PAIF may be a more tax-efficient vehicle for property development activities than a UK REIT in that gains will either be tax exempt or taxed at 20% as trading profit (instead of 28%).
- Unlike for PAIFs, holdings of shares in listed foreign equivalents of UK-REITs do not fall within a UK-REIT's tax exempt PIB.
- Income and capital gains of a UK-REIT arising outside its PIB are taxable at 28%, whereas for a PAIF its non-PIB income is taxable at 20% (with a tax deduction for distributions out of such income) and all capital gains (including from debt instruments and derivative contracts) are tax exempt.
- The effective rate of UK tax on PAIF distributions to non-UK investors from taxable income and exempt capital gains is therefore significantly lower than for UK-REITs.
- A PAIF may have multiple classes of distributing and accumulating shares whereas a UK-REIT may only have one class of ordinary shares and no other type of shares, except non-participating fixed rate preference shares.
- A UK-REIT must distribute at least 90% of its PIB income profits (calculated under UK tax principles) whereas there is no minimum distribution requirement in the case of a PAIF.
- Given that a PAIF is an OEIC, investors must be able to subscribe for/redeem shares on regular dealing days which means that the PAIF's non-PIB (i.e. taxable) portfolio needs to be relatively much larger and more liquid than a UK-REIT's non-PIB portfolio..

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