New investment opportunities

The start of the financial year on 6 April saw Property Authorised Investment Funds gain tax parity with REITs, meaning that tax exempt investors can now use these funds to enjoy tax transparent returns. Property AIFs will no longer suffer a 20% tax on rental income. Following the introduction of the UK REIT in January 2007, the government accepted that there should be a comparable product on offer within the open-ended market. Investors will now be able to choose between closed-ended listed REITs and open-ended unlisted Property AIFs without taxation distorting their choice.

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Framework

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The key elements of the new regime are:

- Only authorised unit trusts that are open-ended investment companies can elect for Property AIF tax status. 100% SDLT relief will be available for authorised unit trusts that will first need to convert to an open-ended investment company in order to elect;
- 60% or more of the Property AIF's underlying investment portfolio must consist of 'property investment business';
- Income distributions to investors will need to be ring fenced within one of three types: property, UK dividends and other income;
- Each Property AIF will need to show HMRC a "genuine diversity of ownership". Investors must not be limited to specific people or groups of connected people;
- Corporate shareholders, which includes life companies, should not own a substantial (10% or greater) interest in the Property AIF. The Treasury has helpfully accepted that companies may invest indirectly without the 10% ownership test being breached;
- In addition to retail schemes aimed at the public, Property AIFs can be classified as qualified investor schemes, intended for institutional and other professional investors. Under FSA regulations, qualified investor schemes are permitted to take on debt finance whereas the scope for retail funds to do this is limited. Qualified investor schemes that elect for Property AIF status will be subject to gearing restrictions, equivalent to a 1.25 income test.

Opportunities

Property AIF status would confer benefits on both existing retail schemes and qualified investor schemes.

Existing retail schemes: By converting and then offering tax transparent returns, authorised unit trusts will be attractive to tax exempt investors such as SIPPs and charities, as well as ISAs.

There would be conversion costs and ongoing operational costs, notably those associated with administering the income distributions. However, if the benefit of attracting a wider investor base is viewed as outweighing such costs, and one or more of the existing retail authorised unit trusts converts (which one player has indicated is its intention), this may produce a domino effect.

Qualified investor schemes: A qualified investor scheme which opts for Property AIF status should be attractive to investors concerned about liquidity and fund managers looking for an onshore vehicle.

Investors may consider that shares in a qualified investor scheme Property AIF meet their liquidity requirements, notwithstanding the residual risk of redemptions being suspended or deferred in a falling market. They may prefer the qualified investor scheme Property AIF to other vehicles, such as a limited partnership or closed-ended unit trusts, which generally offer less liquidity.

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Given the management, control and cost challenges associated with offshore vehicles, the Property AIF seemingly has much to commend it to UK-based fund managers. The Treasury is considering, and it is hoped will soon grant, SDLT relief for offshore property unit trusts which convert to the Property AIF regime.

For non-UK investors holding UK property, Property AIFs will offer tax parity with equivalent vehicles resident offshore, for example, in Luxembourg and the Channel Islands. There will be a 20% (or reduced treaty rate) withholding tax on rental income, but capital gains will be tax exempt.

Conclusion

When looking for an open-ended investment vehicle to hold UK property, fund managers must consider the Property AIF option.

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