

# PROPERTY AUTHORISED INVESTMENT FUNDS

## Background

**1.1** Real Estate Investment Trusts (UK-REITs) were launched on 1 January 2007. During the development of UK-REITs, the Government has continued to consider the taxation position for Authorised Investment Funds (AIF) investing in property.<sup>1</sup> In the 2006 Pre-Budget Report, the Government announced that in taking this issue forward, it had identified a number of significant challenges and committed to continuing dialogue with stakeholders to establish how best to address them.<sup>2</sup>

**1.2** The issue of the taxation of Property AIFs was also raised in an Investment Management Association commissioned report published in October 2006.<sup>3</sup> Following publication of that report, the Economic Secretary announced on 14<sup>th</sup> December 2006, the creation of a joint Investment Management Association, HM Treasury and HM Revenue & Customs Working Group to consider its recommendations.

**1.3** Budget 2007 today announces that, following constructive discussions with the Working Group, industry and other representative bodies, a framework has been developed for taking this issue forward. The framework moves the point of taxation from the AIF to the investor, with the result that investors face broadly the same tax treatment as they would have had they owned real property or UK-REIT shares directly.

**1.4** The framework takes account of many of the same international tax issues that had a bearing on the discussions about, and eventual design of, the UK-REIT. Its key structural features are as follows.

## Level of Property Holding

**1.5** Access to any new Property AIF tax regime will be available only to AIFs whose investment portfolio comprises predominantly real property or shares in UK-REITs. Subject to further discussions with industry, the Government thinks the property-holding requirement will be similar to that of UK-REITs.

## Elective Regime

**1.6** AIFs meeting the property-holding requirement would be able to elect into any new tax regime for Property AIFs, i.e. any new regime would not be mandatory simply because an AIF met the property-holding requirement.

## Ring-fencing of different types of income

**1.7** As for UK-REITs, it is necessary to ring-fence property income so that it remains identifiable as it passes through a Property AIF and out to its investors, who are taxed as if they owned the real property or UK-REIT shares directly.

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<sup>1</sup> *UK Real Estate Investment Trusts: a discussion paper*, HM Treasury and Inland Revenue, March 2005; *2005 Pre-Budget Report: Britain meeting the global challenge: Enterprise, fairness and responsibility*, HM Treasury, December 2005

<sup>2</sup> *2006 Pre-Budget Report: Investing in Britain's potential: Building our long-term future*, HM Treasury, December 2006

<sup>3</sup> *Taxation and the Competitiveness of UK Funds*, KPMG, October 2006

**1.8** However, unlike UK-REITs, Financial Services Authority regulations require Property AIFs to value their fund each day – the ‘daily-pricing’ requirement. This includes a precise allocation of fund income and expenses between property and other income to calculate the impact of tax on the value of the fund. To enable Property AIFs to price daily while ring-fencing property income, discussions with industry have resulted in the Government proposing to ring-fence three types of income for Property AIFs. This will work as follows:

- to opt into any new Property AIF regime an AIF will be required to operate separate pools for three different types of income;
- the pools will be “Property Income”, “Other Taxable Income” (primarily interest and non-UK dividends) and “UK Dividend Income”; and
- the “Other Taxable Income” pool will operate in much the same way as a “bond fund”, with deductions given for distributions that relate to that pool.

**1.9** This will allow a Property AIF to offset expenses efficiently without having to factor tax into its daily pricing calculation. Investors will receive up to three types of distribution each year – a ‘property income’ distribution, an ‘interest’ distribution, and a UK dividend.

**1.10** Each of these distributions would be subject to the UK tax rules applicable to that form of income in the hands of the recipient. For example, individuals and company investors would be taxable on the property income or interest distribution at their normal rates. If the investment is held via an ISA or the investor is exempt from tax on property or interest, the tax would be nil.

## **Type of Authorised Investment Fund**

**1.11** AIFs can be constituted either as Authorised Unit Trusts (AUT) or as Open-ended Investment Companies (OEIC). Many of the UK’s double taxation treaties deal differently with these two legal entities. To help ensure that the UK retains a fair proportion of tax on income from UK land and property, any new Property AIF regime will be available only to those established as OEICs. Existing Property Authorised Unit Trusts will have to convert to OEICs if they wish to take advantage of it.

## **Ten per cent Corporate Ownership Test**

**1.12** As for UK-REITs, in order to help ensure that the UK retains the ability to tax investors fairly on income from UK land and property, a rule will be required for any company that owns ten percent or more of a Property AIF. However, both Government and the fund industry acknowledge that designing this rule will be challenging given the open-ended structure of AIFs and their cross-section of institutional investors. Developing this rule will be the subject of further discussion.

## **Genuine Diversity of Ownership**

**1.13** To avoid Property AIFs being used to obtain unintended tax advantages, it is necessary to include a test based on “genuine diversity of ownership”. This is achieved for UK-REITs by limiting access to the regime to companies that are not ‘close’ (i.e. not controlled by five or fewer participators), which is a long-established concept of company taxation. Both Government and industry agree that while this principle needs to be carried across to Property AIFs, applying the concept in an open-ended

environment will be challenging. Again, the detail of how to achieve genuine diversity of ownership for a Property AIF will be the subject of further discussion.

## Entry Charge

**1.14** The Government does not envisage that there will be a requirement for an entry or membership charge for any new Property AIF regime.

## Next Steps

**1.15** The Government intends to use this framework as a basis for further discussions with the industry and its representative bodies.<sup>4</sup> The Working Group announced by the Economic Secretary will continue to provide a focus for this work.

**1.16** As noted above, some of the issues which remain for discussion are likely to be challenging to resolve. However, subject to how those discussions progress, the Government aims either to publish a technical paper in the summer setting out proposals for how each part of the framework will operate, or, if significant progress is made on the technical detail, to move directly to draft regulations on which it will consult. This will be accompanied by a partial regulatory impact assessment.

**1.17** If you have any questions about the framework or wish to put forward views on the issues raised above, please contact, Gary Coombs on 020 7270 6031, Huw Talbot on 020 7270 6029 or John Buckeridge on 020 7147 2560. Alternatively, e-mail [huw.talbot@hm-treasury.x.gsi.gov.uk](mailto:huw.talbot@hm-treasury.x.gsi.gov.uk).

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<sup>4</sup> Representative bodies consulted to date include the Investment Management Association, British Property Federation, Association of Real Estate Funds, Royal Institution of Chartered Surveyors and the Investment Property Forum.