



## Indirect Investment

### Property Authorised Investment Funds - where are we going?

The Government has introduced tax breaks for UK property funds. But are there still too many unanswered questions to make Property Authorised Investment Funds a viable vehicle?

Since April 2008 when the new tax regime was introduced, no Property Authorised Investment Funds (PAIFs) have been established. Market conditions have played a large part in this lack of action. However, there are still practical and tax issues to be resolved.

#### TYPES OF AUTHORISED FUNDS

Before a fund can become a PAIF it must be authorised. The real estate Authorised Fund market is relatively small in the UK, at about £7.45bn. Germany has demonstrated how popular open-ended real estate funds can be – commanding an €84bn market.

Authorised Funds are of 2 legal types:

- An open-ended investment company (OEIC); where the investor holds shares in a company; or
- A unit trust; where the investor holds units in a trust.

Until 2007 all Authorised Funds investing in real estate were established as unit trusts. This was driven by the familiarity of unit trusts in the real estate sector. Now a few have emerged in OEIC form. In order to qualify as a PAIF, an Authorised Fund must be an OEIC. This will be a change that fund managers must take on board.

#### FORMS OF AUTHORISED FUNDS

While there are two legal types, there are various regulatory classifications, regardless of the legal form taken.

Real estate is not an eligible asset for a UCITS fund. In the UK non-UCITS retail schemes (NURS) are funds outside the UCITS framework and can include real estate as an asset.

In the UK there are, in addition to NURSs, Qualifying Investor Schemes (QIS). These are aimed at sophisticated investors, being institutions or individuals with sufficient expertise to understand the risks. QIS are subject to lighter product regulation than NURSs. For a comparison of the differences see the table on the next page.

We see fund managers using the QISs with the PAIF tax status. This may create a product suitable for institutional and professional investors and which is taxed like a REIT.

#### EXIT AND PRICING

OEICs are open-ended. This means that on notice an investor can get his investment back from the OEIC rather than having to sell his shares to a third party to achieve an exit.

A fund manager will have to be prepared to manage an open-ended

#### What is a UCITS scheme?

A UCITS scheme has to comply with a set of EU directives that aim to allow funds to operate freely across the EU on the basis of a single authorisation from one member state. The idea is to create a single market.

vehicle to take advantage of the PAIF regime. Most real estate funds aimed at institutional investors are unauthorised and closed ended.

The pricing of redemptions is based on net asset value. In July 2007 there was outcry when fund managers appeared to unilaterally change the exit price to investors. Fund managers were protecting investors who stayed in the funds by passing the costs of meeting exits, such as property sales, to exiting investors. In previous market conditions, exiting investors were effectively paid net asset value by new investors entering the funds. Investors and the press had not fully appreciated the bid-offer spread methodology.

#### EUROPEAN DEVELOPMENTS

The European Union is assessing if the current law deprives private investors of real estate product choices.

Today, fund managers cannot market a NURS to investors living in other EU

# We see all new Property Authorised Investment Funds being established as OEICs and electing to be taxed like REITs.

countries. This is unless the fund is approved by the regulators in each country and complies with the terms for regulated funds in each country. This is a near impossible task. Apart from the huge amount of time and cost incurred to achieve this, each country has different requirements, some of which conflict.

To examine the discriminating issue for real estate funds, the EU commission set up an Expert Group. Nabarro partner Deborah Lloyd is a member of this Expert Group. The Expert Group looked at the current barriers to passporting, the existing national laws and the options for an EU passporting regime for real estate funds.

The Expert Group produced its report in March 2008.

There could be changes here, but enabling legalisation is unlikely to materialise until 2012.

## TAXATION

The Authorised Funds taxation model was designed to deal with funds investing in equities and bonds rather than property. An Authorised Fund is taxed as a corporate: it is subject to corporation tax but at the lower rate of 20%.

Authorised Funds may make two different types of distributions depending on the type of income they earn. Where 60% or more of a fund is invested in bonds then interest distributions can be made. These are allowable as deductions in computing profits for tax purposes but, due to the 60% test, are not likely to be relevant to Authorised Funds holding property. Where the 60% test is not met, then only dividend distributions can be paid out. Like any corporate, dividend distributions paid out by an Authorised Fund are not deductible in computing the amount of taxable profits.

Direct property holdings by the Authorised Fund would generate rental income, which would be taxed at 20%.

Restrictions relevant to real estate		
	NURS	QIS
Redemption periods	Daily - to - 6 months. In practice daily redemptions	Specified in prospectus
Borrowing limit	10% LTV	50% LTV
Investment limits		
Property company shares	Up to 20% of fund value unless shares listed	No restriction
1 property	Not more than 15% of fund value	No restriction
Income receivable from one group	Not more than 25% of all income (35% if government income)	No restriction
Non-income producing or under development	Up to 50% of fund property	No restriction
Limit on mortgaged property	Up to 20% of property values	Up to 100% of property values
Investment in SPVs	Overseas property can be held in SPVs	Wholly owned SPVs permitted

# Authorised Funds holding property can elect to be taxed in a similar way to REITs.

The only UK investors for whom the system is inefficient are lower rate taxpayers or non-taxpayers which includes charities, pension funds and life companies who cannot claim back the tax credit and so the tax paid by the Authorised Fund is an actual cost.

## THE PAIF REGIME

Authorised Funds holding property can elect to be taxed in a similar way to REITs.

PAIF has become the new acronym to describe the Property Authorised Investment Funds that elect into this tax regime.

The framework, introduced in April 2008, moves the point of taxation

from the PAIF to the investor, with the result that investors face broadly the same tax treatment as they would have had they owned real property or REIT shares directly. This means low or non-taxpayers are not disadvantaged.

While there is no REIT-style conversion charge, there will be costs of converting existing structures into PAIFs. Stamp Duty Land Tax is a big hurdle. Whilst existing Authorised Funds can convert SDLT free, there is no exemption for Unauthorised Unit Trusts to convert and not pay SDLT. This in itself will be an impediment to the idea some have that PAIFs are the catalyst to bring the offshore funds back on shore.

Another deterrent is that no corporate shareholder can be directly entitled to more than 10% of the net asset value of the fund. This could be overcome with an Authorised Unit Trust acting as a feeder. Following the 2008 Pre-Budget Report, the use of such feeders has become easier as an SDRT exemption for feeder funds and simplified regulation regarding distributions to feeder funds has been introduced. However it adds to the complexity of the structure.

## CONCLUSION

In the light of the new regime, fund managers should consider whether existing unit trusts should be converted to OEICs to benefit from the new tax regime. This will depend partly on whether the costs of conversion outweigh the benefits to investors. When the market permits, we see all new property Authorised Funds being established as OEICs and electing to be taxed like REITs.

Without lobbying to change many of the tax rules, it is unlikely off shore funds will come back on shore.

In time, combining the ability to hold foreign property in SPVs, the flexible regulations of QIS and tax transparency may give business opportunities to fund managers to offer new vehicles to the market.

### The highlights of the PAIF regime:

- OEICs (but not unit trusts) will have the benefit of REIT style taxation. This is why OEICs are likely to be the vehicle of choice going forward.
- There will be no entry or conversion charge.
- The regime will be elective not mandatory.
- SDLT will not be triggered for funds transferring from an authorised unit trust to OEIC form.
- The funds will need to have a wide shareholder base and "genuine diversity of ownership".
- The property portfolio must comprise property holdings of 60% or more (40% in first year).
- 60% of income must come from property investment business (40% in first year).
- Listed REITs count as property holdings.
- Foreign property held in an SPV counts as a property holding
- Breach of the conditions is not fatal. It is recognised that redemptions may cause breaches.



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CLARITY MATTERS

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Legal 500, 2008

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