New UK real estate fund vehicles

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Tax treatment of new UK Real Estate Fund vehicles

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What is this about?

- Major shifts in the UK investor market;
- New real estate fund vehicles.

Major shifts in the UK investor market

- Decline in UK property funds for retail investors since 2016;
- Decline of defined benefit pension schemes:
    - Long-term decline of corporate defined benefit (DB) pension schemes;
    - Accelerated by the Liz Truss mini-budget and the LDI crisis;
    - Transfer of liabilities to insurers in the bulk annuity market;
    - Local Government Pension Scheme in net outflow;
- Rise of defined contribution pension provision, but it is slow;
- UK out of favour with overseas investors.

Why is this important?

The issue

Long-term decline of corporate DB pension schemes

Industry objectives

Making it easier for DC schemes to invest in real estate and other illiquid assets

Widening the Solvency II Matching Adjustment rules so that more real estate can sit in bulk annuity investments

The new UK real estate fund vehicles

- The Long-Term Asset Fund (LTAF);
- The Reserved Investor Fund (RIF);
- Private real estate investment trust (REIT) owned by a fund vehicle;
- Qualifying Asset Holding Company (QAHC) owned by a fund vehicle

The Long-Term Asset Fund (LTAF)

What is it?

- Can be a Co-ownership Authorised Contractual Scheme (CoACS), Authorised Unit Trust (AUT) or an Open-Ended Investment Company (OEIC);
- “Permitted link” for DC pension investment – designed for DC schemes to invest in illiquid assets;
- Accessible to certain retail investors;
- Open-ended, with redemptions no more frequently than monthly with at least a 90 day notice period.

Long Term Asset Fund (LTAF) - Tax treatment

- Existing tax regimes apply where relevant, i.e.:
  - CoACS
  - AUT
  - OEIC (which includes a Property Authorised Investment Fund (PAIF))

- For the purposes of the REIT non-close condition and the exclusion from the listing requirement, the above, together with a CIS partnership, are treated as institutional investors, provided they meet either the non-close/Genuine Diversity Ownership ("GDO") condition.

The Reserved Investor Fund (RIF)

What is it?

It is Co-ownership Contractual Scheme but is not an authorised fund. It provides an onshore alternative to an offshore unit trust.

Does not yet exist – draft regulations currently out for consultation.

The Reserved Investor Fund (RIF) - Conditions

- A co-ownership scheme (within section 235A of FSMA 2000): which is not authorised contractual co-ownership scheme which:
  - is an Alternative Investment Fund
  - meets the conditions set out in section 261E(2) and (3) of the FSMA 2000 (participation limited to professional or large investors),
  - meets the non-close/GDO condition, and
  - satisfies one of the following restriction requirements:
    - is UK property rich or
    - is restricted to investors who are exempt from tax on gains (other than by reason of non-residence) similar to an Exempt Unauthorised Unit Trust ("EUUT"), or
    - does not directly invest in UK property or in UK property rich companies (with one exception - similar to para 7B Sch 5AAA TCGA 1992)

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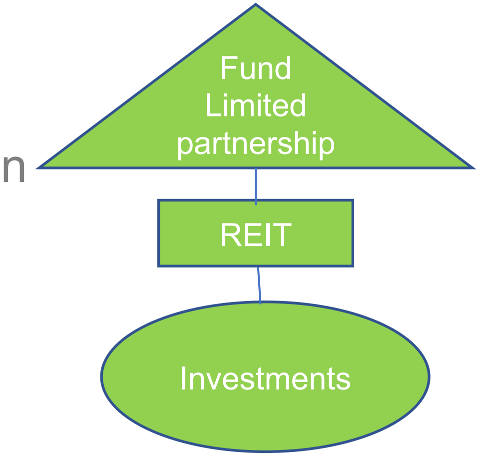
The Reserved Investor Fund (RIF) - Tax treatment

- Income - transparent (but the operator can calculate CAs cf a CoACS)
- Capital gains:
  - RIF is not a person for capital gains purposes
  - Units are treated as a chargeable asset (UK tax resident investors)/shares (for NRCG)
  - Reverts to transparent status if conditions breached (subject to mitigations)
- SDLT - The RIF is treated as a company (but not for group relief purposes), with limited seeding relief
- Stamp Duty/SDRT - the RIF is transparent on first principles, with certain exemptions
- VAT - Supplies made will be subject to the usual VAT rules

Private real estate investment trust (REIT) owned by a fund vehicle



What is it?

The REIT is a tax efficient real estate investment vehicle introduced in 2007. Until 2022, it had to be listed. It can now be unlisted if it meets an ownership test of more than 70% institutional investors. Certain fund vehicles including a fund limited partnership are regarded as an institutional investor.

Private Real Estate Investment Trust (REIT)

Recent relaxations to the UK REIT requirements which facilitate the use of REITs in fund structures include:

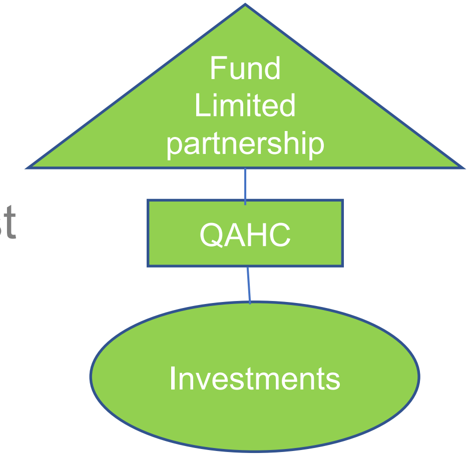
- removal of the listing requirements where the REIT is at least 70% owned by institutional investors (which includes a CIS partnership which meets the non-close/GDO condition);
- changes to the non-close requirements (to include non-close/GDO CIS partnerships, CoACS and ‘indirect’ institutional investors;
- relaxation in relation to the holders of excessive rights provisions in respect of investors who are entitled to gross payments of property income distributions and beneficiaries under certain double tax treaties; and
- an alternative to the three property condition where there is a single non-residential property worth at least £20m

However the profit:finance cost ratio remains (subject to some limited relaxations), and this applies before taking into account the corporate interest restriction.

Qualifying Asset Holding Company (QAHC) owned by a fund vehicle

What is it?

The QAHC is a new tax efficient investment vehicle introduced in 2022. It is attractive for debt funds. It needs to meet an ownership test of more than 70% institutional investors. Certain fund vehicles including a fund limited partnership are regarded as an institutional investor.



Qualifying Asset Holding Company (QAHC)

Benefits of the QAHC regime (which, inter alia, make it attractive for debt funds) include:

- exemption from tax on gains on the disposal of shares (other than UK property rich shares) and overseas property;
- exemption from tax on income from an overseas property business where those profits are subject to tax in an overseas jurisdiction;
- no requirement to deduct income tax at the from payments on yearly interest;
- deduction for interest and other finance costs on debt (including profit participating and convertible debt) on an accrual basis subject to an arms length margin; and
- ability to make returns to investors in a capital form, subject to certain restrictions, free from stamp duty and stamp duty reserve tax.

However there are potential disadvantages in holding UK property rich shares in a QAHC, and a QAHC cannot be a member of a group UK REIT

The GDO condition

For both the REIT and QAHC ownership test, the partnership must be a collective investment scheme that meets a genuine diversity of ownership (GDO) condition The GDO condition is therefore going to be key. For this, there are three conditions that need to be met:

- Condition A requires that the marketing documents for the fund state that interest in the fund will be widely available, specify who the intended categories of investor are and confirm that the fund will be marketed and made available to those target categories;

- Condition B requires neither the specification of the intended categories nor any of the terms and conditions of the fund should be set in such a way as to limit investment to a select group within the stated categories of investors and they should not deter a reasonable investor within the intended categories of investor from investing in the fund;

- Condition C excludes any fund that, despite meeting Conditions A and B, does not in practice act in a way that supports the statements it has made as to the intended categories of investor.

The fund offering documents and marketing will be key.

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Thank you