

**CTM48810 – Property Authorised Investment Funds (Property AIFs):
introduction and conditions of membership: contents**

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CTM48811: Property Authorised Investment Funds (Property AIFs): introduction and conditions of membership: introduction

Reference to these pages

These pages should be read as part of the guidance published in respect of 'The Authorised Investment Funds (Tax) Regulations 2006' (SI 2006/964), which can be found in the Company Taxation Manual at CTM48000 onwards. The material at CTM48000 applies to property Authorised Investment Funds in the same way as to other authorised funds, except as set out in Part 4A of the regulations (inserted by SI 2008/705) and explained in the following chapters.

What is a Property AIF?

A Property AIF is a form of Authorised Investment Fund whose investment portfolio comprises predominantly real property or shares in UK Real Estate Investment Trusts (UK-REITs) and certain other similar entities (see CTM48813 for further details).

The intention of the Property AIF regime is to tax investors in a similar way to those that invest directly in the underlying assets and to remove tax barriers in the way of collective investment in rental property. So, the regime exempts property income and gains from corporation tax, similarly to the way the UK-REITs regime exempts property income gains from corporation tax for companies that are not collectives. This then allows an open-ended fund to be exempt from corporation tax on property income and gains in a similar way to that achieved for UK-REITs.

As Property AIFs may have a mix of income (they are only required to derive 60 per cent of their net income from the property income business), it is necessary to ring-fence property income as it passes through the fund to ensure that it remains identifiable. This income is tax-exempt in the hands of the fund. It is treated for UK tax purposes, once the expenses of managing the property have been paid, as property income. The investor then pays tax on the amount received as if it were the profits of UK property business (irrespective of whether the property income is derived from the UK or overseas).

The other main form of taxable income likely to be received by a Property AIF is interest (or economically equivalent income) on funds invested whilst awaiting opportunities within the property investment business or to provide a convenient buffer for expected redemptions. This category of income could also include foreign dividends, in cases where these do not count as property income. This income will be within the charge to corporation tax, but the Property AIF will be able to get a deduction for tax purposes when it is distributed. It is treated for tax purposes in the same way as other savings income (such as interest on a bank account).

Finally, the Property AIF may also receive dividends from UK companies which are not chargeable to corporation tax. Again, this income is treated for UK tax purposes as if it is dividends.

This means that, in general, an investor will pay approximately the same level of tax as if they had invested directly in the underlying assets. In order to achieve this, the fund must make distributions to investors in a way that enables the investor to identify the amount attributable to the different types of income, and to pay tax on them accordingly.

This means that the fund's total income will fall into one of the following three pools:

- property income (including property income from UK-REITs and foreign equivalents),

- 'other taxable income' (primarily interest and non-UK dividends)
- 'UK dividend income'

so that investors will receive three different types of income.

The Property AIF is chargeable to corporation tax, but the regime enables a Property AIF to manage itself in such a way that it should be able to ensure that tax does not 'stick' in the fund, but rather all income flows through to the investors who will then be charged to tax at the appropriate rates for property income, savings income and dividend income respectively.

It is not intended that individuals or companies should, in comparison, with direct investment in the underlying assets, gain a tax advantage by investing in a Property AIF and there are, accordingly certain circumstances in which a corporation tax charge could arise to a Property AIF. (These are set out at CTM48834 to CTM48838.)

For an AIF to be within the Property AIF regime it must:

- be an open-ended investment company (OEIC),
 - have given notice to HMRC to come within the Property AIF regime which is set out in Part 4A of SI 2006/964 (the Authorised Investment Fund regulations) and explained in this guidance at CTM48822,
 - meet certain conditions (set out in Part 4A SI 2006/964 and also detailed in this guidance) at CTM48813 to CTM48819.
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CTM48812 – Property Authorised Investment Funds (Property AIFs): introduction and conditions of membership: overview of conditions

The Property AIF regime is elective. The manager of the fund, or proposed manager, must give advance notice in writing that it wants the Property AIF rules to apply from a given date to the fund, its distributions and investors who receive those distributions. The fund must be an open-ended investment company (OEIC), as defined in section 236 Financial Service and Markets Act 2000 (FSMA) and regulated by the Financial Services Authority (FSA) and meet the following conditions:

- the property investment business condition
- the genuine diversity of ownership condition
- the corporate ownership condition
- the loan creditor condition
- the balance of business condition, and where relevant
- an additional condition for Property AIFs that are qualified investor schemes

The conditions have to be met throughout the period the Property AIF wants to be within the regime. More detailed guidance on these conditions is given in CTM48813 – CTM48819. Once HMRC accept that the OEIC meets the conditions, the regime applies from the date specified in the original notice, and not from the day the notice is given. Further information is given on this in CTM48822.

In the case of an OEIC the manager is the authorised corporate director (defined in regulation 6(3)(a) SI 2006/964).

CTM48813 - Property Authorised Investment Funds (Property AIFs): introduction and conditions of membership: the property investment business condition

In order for this condition to apply under regulation 69E SI 2006/964, the open-ended investment company (OEIC) must meet two conditions:

- the manager must ensure that that the OEIC's instrument of incorporation and prospectus states that its investment objectives are to carry on a property investment business (PIB) and to manage the cash raised from investors for investment in the PIB (regulation 69E(2) SI 2006/964)
- the OEIC must carry on a PIB

For these purposes, a prospectus (or proposed prospectus of a proposed OEIC) includes any supplements to it.

A PIB must be a continuing business that consists of one or more of the following (regulation 69F SI 2006/964):

- a Property Rental Business (see below)
- owning shares in UK REITs
- owning shares (which in this context includes units – see regulation 69F(1)(c)) in foreign entities that are equivalent to UK-REITs (see CTM48814)

A Property Rental Business (regulation 69H SI 2006/964) is defined in section 104(2) FA 2006 for UK-REITs. Under this definition it includes:

- a. a Schedule A business (within the meaning of section 832(1) ICTA), or
- b. an overseas property business (within the meaning of section 70A(4) ICTA)

but subject to specified exclusions listed in Schedule 16 FA 2006.

Part 2 of Schedule 16 provides a list of items normally within (a) or (b) above but which are specifically excluded from the Property Rental Business. These are:

- rent in respect of electric line way leaves
- rent in respect or for pipelines for oil or gas
- rent in respect of the siting of a communications mast (eg: for mobile telephones)
- rent in respect of the siting of a wind turbine
- income in respect of interest in a limited liability partnership where section 118ZA (4) of ICTA (winding-up) applies.

Schedule 16 excludes dividends from UK-REITs, but in as far as they arise from the tax-exempt business of the UK-REIT, but they are separately included in the PIB as explained above.

Part 1 of Schedule 16 excludes the provision of services in connection with overseas property where the services would not fall within Schedule A if the property was in the United Kingdom. It also excludes entering into structured finance arrangements to which section 774B or section 774D of ICTA applies (factoring of rent and other income).

Given that a Property AIF will not be carrying on a trade, and cannot be part of a group for tax purposes (regulations 94(5) and 107 SI 2006/964), the other provisions in Part 1 of Schedule 16 will not affect a Property AIF.

CTM48814 - Property Authorised Investment Funds (Property AIFs): introduction and conditions of membership: foreign equivalents to 'UK-REITs'

Where a Property AIF owns shares in foreign entities equivalent to UK Real Estate Investment Trusts (UK-REITs) then the shares will be assets of the property investment business (PIB) (Regulation 69F(c) SI 2006/964). The basic characteristics of a UK-REIT are that it invests mainly in property and that it is exempt from corporation tax on property income. There are certain other characteristics that must also be present. (See below.)

In order to be equivalent to a UK-REIT the foreign entity:

- Must be exempt from tax on property income in the jurisdiction in which it is incorporated or carries on its business (regulation 69F(5) SI 2006/964).
- Must be a property company, a unit trust scheme or similar arrangement (regulation 69F(3) SI 2006/964).
- Must be listed on a recognised stock exchange (as defined by section 1005(1) of ITA 2007).
- Must not be a collective investment scheme (as defined by section 235 FISMA) (regulation 69F(3)(b) SI 2006/964. If it is a company it cannot be an open ended investment company as defined by section 236 FISMA (regulation 69F(6)(b) SI 2006/964 (regulation 69F(6)(b)).
- If it is not a company must have defined capital and should not have any obligation to provide opportunities for redemption of the investment, nor should it have a mechanism to enable investors to sell their investment at or around the underlying net asset value (regulation 69F(3) SI 2006/964).
- Is not within the charge to corporation tax.

HM Revenue & Customs (HMRC) considers that the following structures are equivalent to UK-REITs:

[List to be issued in final guidance.]

No other structures should be accepted as being equivalent to UK-REITs by HMRC without agreement from CT&VAT Financial Services.

If it is argued that any other structure is equivalent to a UK-REIT, then it must be established that it not subject to corporation tax and that its property income is exempt from tax in its home jurisdiction, or is subject to tax in such a way to achieve the economic effect of exemption. If these basic requirements are met then HMRC should establish how its capital is defined, how investors can realise their shares or units and whether it is required to be listed on a recognised stock exchange. Having obtained this information, all such cases should be referred to CT&VAT Financial Services for advice.

If the shares are assets of the PIB then the income from those shares will be income of the PIB except in as far as any of that income is specifically identified by the payer as not arising from the tax-exempt property business of the payer.

A Property AIF is not be required to analyse the income received from a foreign entity equivalent to a UK-REIT for the purposes of pooling income except in so far as the paying entity itself identifies separate pools within its distribution, as is the case with UK-REITs from which distributions are pooled accordingly (regulation 69G(3) SI 2006/964).

CTM48815 - Property Authorised Investment Funds (Property AIFs): introduction and conditions of membership: intermediate holding companies

The definition of Property Rental Business also includes the relevant business of an intermediate holding vehicle (regulation 69H(1) and (2) SI 2006/964 and section 104 FA 2006). The 'relevant business' of an intermediate holding vehicle is all that part of the overseas property business of the vehicle which would be within the Property Rental Business if it were directly carried on by the Property AIF.

The full conditions that must be fulfilled by an intermediate holding vehicle can be found at regulation 69I SI 2006/964. The purpose of this regulation is to enable investment in foreign property, in jurisdictions where local restrictions prevent the Property AIF from holding property directly.

An 'intermediate holding vehicle' must:

- Be a company, trust or partnership which is not a collective investment scheme.
- Be wholly owned either by the Property AIF parent or by another intermediate holding vehicle, except in as far as local legislation relating to the vehicle requires a proportion of local ownership.
- Have its accounts consolidated with those of the Property AIF.
- Ensure that all its property rental income (or the full proportion of that income representing the interest of the Property AIF) must be reflected in the distribution accounts of the Property AIF at the same time as the income is reflected in its accounts.
- Have as its sole function to enable the holding by the Property AIF of real property located outside of the UK. It does not include foreign real estate investment trusts.

'Enabling the holding of property' will include activities ancillary to the Property Rental Business providing that these activities are carried on purely for the purpose of enabling the Property Rental Business to exist, continue or prosper. If any of these activities would fall outside a Schedule A business if carried on in the United Kingdom, then the income from those activities will not be included in the Property Rental Business and so will be part of the non tax-exempt (residual) income of the Property AIF (see CTM48833).

CTM CTM48816 - Property Authorised Investment Funds (Property AIFs): introduction and conditions of membership: the genuine diversity of ownership condition

Regulation 69J SI 2006/964 is essentially legislation to prevent the regime being manipulated by a small group of people or a larger connected group who may intend to gain a tax advantage. It sets out six conditions (A to F) that must be met by a Property AIF.

On entry

Conditions A and B must be satisfied before notice of entry can be given. They can be satisfied by the inclusion of appropriate binding statements in the fund documentation as explained below. There is an advance clearance process to enable the intended manager of a proposed Property AIF to check that they will be able to meet this condition (see CTM48824).

Condition A: The Property AIF is required to specify its intention to make its shares widely available and to specify its intended categories of investor in its instrument of incorporation and its prospectus. These documents will be considered by HM Revenue & Customs (HMRC) when a manager gives notice for the open ended investment company to join the regime and the notice should be 'quashed' (see CTM48823) if the required statements (regulation 69J(2) SI 2006/964) are not set out in the instrument of incorporation and the prospectus.

Condition B: (regulation 69J(3), (8) and (9) SI 2006/964) This requires the target investment market not to be limited to specific investors (or groups of connected investors). On receipt of a notice HMRC should check the intended categories of investor as specified in the documents and if (counting a group of connected persons as one person) the intended investors are restricted to specific and identifiable companies or individuals the notice should be quashed (see CTM48823 for more details).

Regulation 69J(8) and (9) SI 2006/964 allows HMRC to take into account the intended categories of investors in an associated unit trust scheme described as a feeder fund in establishing whether this condition is met. You can only do this if the feeder fund has the same manager as the intending Property AIF and its documentation is included with the notice of entry for the Property AIF (regulation 69J(9) SI 2006/964).

As an example, HMRC does not consider that this regulation rules out a fund that starts out being seeded by only a single life insurer as an indirect investor via a single feeder fund so that the corporate ownership condition is not breached – see CTM48873. However, as explained below, it must then be available to and marketed to other similar companies including competitors of the existing insurance company investor. There should be no exclusions of investors of a type to within the target market.

HMRC would not seek to exclude a case where the only beneficial investor was a unit trust scheme (feeder fund) providing that the unit trust scheme would, itself, satisfy the genuine diversity of ownership condition.

Connected party in this context takes its meaning from section 839 ICTA (regulation 69J(10)(b) SI 2006/964).

After Entry

Conditions A and B must continue to apply. In particular if the fund documents (or the feeder fund documents if these accompanied the notice) are altered in any relevant respect then it is

possible that the fund may then fail these conditions. Any clearance that may have been given by HMRC can no longer be relied upon and the manager should inform HMRC of the changes that have been made.

Conditions C, D, E and F: These are, in effect, requirements that the manager continues to act in accordance with the Property AIF's prospectus to attract investors in its stated target market. These conditions are necessary as the first two conditions can be met by documentation alone and do not require the fund to have actually achieved a spread and number of investors in accord with its prospectus.

Each of these conditions is designed to ensure that the shares are actually available and marketed to all the stated categories of investor.

In considering whether any of these conditions have been breached HMRC should have regard to:

- what form of marketing is appropriate to reach the intended categories of investor
- checking that information on the Property AIF and access to facilities to purchase its shares, is easily and practically obtainable by a reasonable potential investor within the target market
- check that the minimum investment and charges are not set at a level which would deter a reasonable investor within the target market

If, after considering these points HMRC consider that a Property AIF may be in breach of this condition then the case should be submitted, with full details, to CT&VAT who will advise on further steps.

Advance clearance

There is a clearance arrangement (CTM48824) to enable proposed Property AIFs to check in advance that their proposed arrangements will meet this condition.

CTM48817 - Property Authorised Investment Funds (Property AIFs): introduction and conditions of membership: the corporate ownership condition

Regulations 69K and 69L SI 2006/964 set out the corporate ownership condition. It requires the Property AIF to prohibit any corporate investor from holding 10 per cent or more of the fund by net asset value and to take reasonable steps to ensure compliance with the prohibition by corporate investors. Some Property AIFs may choose to simplify the operation of this process by prohibiting all direct investment by corporate investors. Such a Property AIF will still need to take reasonable steps to check that it does not have corporate shareholders. Examples set out below are not exhaustive but if a Property AIF has carried out the steps set out below then it will be treated as meeting condition A of regulation 69K SI 2006/964.

Examples of reasonable steps include:

- Regularly reviewing the register, which should be undertaken at least once every distribution period.
- Setting up a mechanism to ensure that investors are kept informed of the requirement that no body corporate may hold more than 10 per cent of the units in a Property AIF.
- Setting up a mechanism to warn corporate investors that get close to a 10 per cent or more holding.
- Where a Property AIF becomes aware that a corporate investor has a 10 per cent (or more) holding then the fund manager must notify the corporate investor immediately, must not pay them any income distribution and must redeem or cancel the investor's holding down to below 10 per cent of the net asset value of the Property AIF within a reasonable timeframe. A reasonable timeframe means the period of time which the fund manager reasonably considers appropriate with regard to the interests of other investors in the Property AIF and should be explained to HM Revenue & Customs (HMRC) so that it can be satisfied that a reasonable timeframe will be adhered to.

Further requirements of regulations 69K and 69L SI 2006/964

The Property AIF must include requirements in its documentation that any body corporate which becomes a shareholder:

- Must give an undertaking not to hold more than 10 per cent of the share capital. Also, if it should inadvertently acquire such a holding (this could happen when the Property AIF reduces in size as other participants dispose of holdings) to reduce it to below 10 per cent.
- Must certify that it is the beneficial owner.

In the case of a corporate nominee it must certify that it does not hold more than 10 per cent of the shares on behalf of itself or of any other corporate body and that it has obtained corresponding undertakings to those above from its corporate clients owning the shares held by the nominee (regulation 69K(7) SI 2006/964).

Cases where corporate holders are prohibited by the Property AIF

Whilst this satisfies Condition A (regulation 69K) the property AIF must still take reasonable steps to ensure that there are no corporate beneficial holders. In cases where shares are held

by a nominee there will still be a need to require the nominee to certify that its clients are not bodies corporate (and, if the nominee is a company, that it does not hold shares on its own behalf) (regulation 69L(1) to (4) SI 2006/964).

Indirect holdings via a 'feeder fund'

While the effect of the regulations is to prevent corporate bodies from beneficially holding 10 per cent or more of a Property AIF, it is still possible for a corporate body to have an indirect interest of 10 per cent or more in a Property AIF by holding units in a (non-corporate) 'feeder' fund (regulation 69L(5) SI 2006/964).

In such a case the feeder fund must be the beneficial owner of the shares in the Property AIF and not the corporate body holding the units in the feeder fund. The feeder fund may, for example, be a unit trust.

In cases where shares in the Property AIF are held by the trustees of a unit trust scheme and those trustees are chargeable in their capacity as trustees of the scheme to tax in the United Kingdom then regulation 69L(5) SI 2006/964 provides that the trustees shall be regarded as the beneficial owners of the shares.

In other cases then it will be for the trustees to establish that they are beneficial owners of the shares in their capacity as trustees.

This means that, for example, where an offshore unit trust is transparent it would not satisfy this condition and HMRC would regard the owner of the units in the trust as a participant in the Property AIF. However where the offshore unit trust is not transparent (for example a so-called 'Garland' trust) then it will itself be the beneficial owner for this purpose.

Tax will be deducted in all cases where a property income distribution or a Property AIF distribution (interest) is paid to a non-resident holder (see CTM48858).

CTM48818 - Property Authorised Investment Funds (Property AIFs): introduction and conditions of membership: the loan creditor condition

This condition (69M SI 2006/964) restricts the ways in which the open-ended company can borrow money. The purpose is to prevent income or capital growth being extracted from the Property AIF via a profit-related loan. The Property AIF will be in breach of this condition, if it is the debtor in a loan which is not a normal commercial loan.

The wording in the legislation is similar to the definition of 'normal commercial loan' in paragraph 1(5) Schedule 18 ICTA. For guidance on interpretation of 'normal commercial loan' as defined in Schedule 18 ICTA, see CTM81010 and CTM81020.

CTM48819 - Property Authorised Investment Funds (Property AIFs): introduction and conditions of membership: the balance of business condition

This condition relates to the level of property and income arising from it, that an existing open-ended investment company (OEIC) must meet in order to elect into the regime (Regulation 69N(2)(b) and (3)(b) SI 2006/964). This is that:

- at least 60 per cent of the fund's net income in each accounting period should be derived from the Property Investment Business (PIB)
- at the close of the accounting period, at least 60 per cent of the assets of the fund should be assets of the PIB

'Start-up' funds

In the case of newly Authorised Investment Funds (which excludes conversions from existing Authorised Investment Funds), it is recognised that this level of property holding may be difficult to achieve in the first year. Hence, to allow for this, start-ups must achieve 40 per cent in respect of both income and total value of assets by the end of their first year, with the level then going up to 60 per cent by the end of year two (regulation 69N(2)(a) and (2)(a) SI 2006/964).

Asset valuation

Assets must be valued in accordance with generally accepted accounting practice and if there is a choice of valuation method, then a fair value option must be adopted. Any liabilities secured against or otherwise relating to the assets of the PIB are not taken into account when determining the net assets for the purpose of this condition.
