THE
INVESTMENT
ASSOCIATION

Reserved Investor Fund Consultation

Executive Summary

The IA strongly supports the Government's ambition for innovation in the UK investment fund space and thanks both HM Treasury and HMRC for the opportunity to respond to the consultation on the Reserved Investor Fund ('RIF').

As part of the UK Fund Regime review Call for Input in 2021, the IA urged the government to prioritise the formation of an Onshore Professional Fund Regime, focused on three legal forms: corporates, partnerships, and contractual schemes. In conjunction with AREF, we believed that the Professional Investor Fund ('PIF') should be prioritised as it was considered relatively straightforward in terms of legislative implementation.

At that time, it was expected that the PIF (what would become the RIF(CS)) would broadly mirror the conditions of the existing authorised contractual schemes ('ACS') but offer less regulatory restrictions, freeing the PIF to become a more flexible investment vehicle for a range of more experienced investors. Since then, we understand that HMT and the RIF Expert Group have worked to build a functional tax regime for this product, while considering its vanguard role in, and the importance of, a consolidated alternative investment fund brand of Reserved Investor Funds, a foundational project that the IA warmly supports.

The launch of the RIF consultation is the culmination of this partnership with the hope the RIF can emulate the success of its authorised counterpart – the ACS. However, the RIF and the ACS differ in two key aspects:

- **Treatment of UK property for the purposes of Non-Resident Capital Gains**
- **VAT treatment of management fees**

These differences lead through a complex web of consequences which will likely mean that the RIF(CS) is a product focused solely on UK commercial real estate and whose availability will be limited to specific types of investors who have a strong UK fund location preference. In other words, it may only attract subsets of professional investors, namely exempt investors. This limited scope could fail to convince the global investment community to choose the UK over more competitive jurisdictions. The objectives of the UK Fund Regime review, which aim to make the UK an attractive location for fund setup and facilitate a wider range of investment opportunities, may not be effectively fulfilled by such a targeted product.

As a result of its limitations, RIF(CS) misses the opportunity to be a versatile product capable of being utilised for asset classes, beyond commercial real estate, and a wide range of sophisticated investors. If the RIF(CS) receives a lukewarm response compared to international products like the Luxembourg RAIF, it could also hinder the UK's ambition to be a successful alternative fund hub. **The government is urged to**

The Investment Association

Camomile Court, 23 Camomile Street, London, EC3A 7LL
www.theia.org

anshita.joshi@theia.org

@InvAssoc @The Investment Association

explore improvements to the RIF(CS) to expand the asset classes it can hold and the variety of investors it can accommodate, while ensuring that it does not come at the expense of a complex tax regime.

Our Response to Consultation Questions

1. Do you agree that the 'Reserved Investor Fund (Contractual Scheme)', or 'RIF(CS)', is the most appropriate name for the new structure? If you disagree or suggest a different name, please give reasons for your response.

Yes, we agree.

2. Would a restricted RIF add value to the existing range of UK fund structures, particularly compared to a structure without such restrictions? What would the relative attractiveness be of the proposed restrictions to the RIF regime?

We consider that a restricted RIF, aimed at a narrow set of investors with investment primarily in commercial real estate, is a welcome addition to the specific segment of the market. While acknowledging that no investment product will perfectly suit the demands of every investment nor every investor, and the need for a balance between commercial appeal and Exchequer protection, we have the following concerns with the proposals.

- **Limited appeal.** With various risks of falling outside of the regime, based on the restrictions proposed in the consultation, the product is expected to be best suited to a specified group of investors (exempt from UK capital gains tax) or viable for funds that invest only in UK commercial real estate or foreign commercial real estate.

  The intractability of the UK's approach; that they will entertain *'no risk of loss of tax from non-UK resident investors on disposals of UK property'* has at this relatively late juncture, made the RIF(CS) significantly less competitive compared to its rivals.

  The proposed restrictions on the RIF(CS) could limit its commercial viability and make it susceptible to being overshadowed by less constrained products in the market. It is unclear what advantages the RIF(CS) will offer compared to similar products. Originally, the PIF aimed to be a cost-effective and quick-to-market fund with tax parity to the ACS. However, the current version of the RIF(CS) has lost some of these advantages, while still maintaining its appeal as a UK-based fund. The limited investment options, such as UK or foreign commercial property, and various regulatory requirements like VAT registrations and compliance with AIF funding and GDO and Non-Close Tests, may hinder the RIF(CS)'s speed to market.

  The proposal includes three separate and more constrained versions of the RIF(CS), making it less likely to compete effectively as a versatile vehicle. This could result in a reduced investor pool and insufficient market interest for the RIF(CS) to be considered a viable option for operators.

  The success of the RIF(CS) will depend on investors' sensitivity to these competitive constraints against already established and popular property holding products like Jersey or Guernsey Property Unit Trusts or other widely attractive and versatile vehicles like Luxembourg RAIFs, Irish Qualifying Investor Alternative Investment Fund (QIAIFs) and indeed UK ACSs.

- **AIF requirements.** While not being consulted on, we understand that this RIF(CS) has been designed as an Alternative Investment Fund falling within AIF regulations. The AIF regulations contain various requirements and restrictions, making it difficult for certain types of structures such as funds of one, joint ventures and co-investment vehicles to qualify as an AIF. Although not structures primarily used by IA members, the structures are commonly used in real estate and indeed alternative funds market and while working around the AIF requirements in these cases may be possible, it may be expensive or cumbersome to do so.

3. Are there investment asset classes besides real estate for which a RIF would be particularly attractive?

Theoretically, the RIF(CS) should, like an Irish QIAIF Common Contractual Fund (CCF) or a Luxembourg RAIF Fonds commun de placement (FCP), be open to all asset classes. Indeed, the RIF(CS)'s authorised counterpart, the ACS in its co-ownership form (CoACS), has been extremely successful as a product in utilising its income transparency to supplant its corporate counterparts across a number of different investment strategies.

Many CoACSs are set up for the benefit of treaty-eligible investors who are entitled to reduced withholding tax rates through double tax treaties. The most popular of these are US equity CoACSs which can offer a 0% withholding tax rate to a pension scheme investor base, which compares favourably against US investments by UK OEICs or similar vehicles which will suffer the more common 15% withholding tax rate. CoACS have been utilised in this way to invest in a wide variety of asset classes including equity, bonds, real estate etc and have consequently proved to be a very popular vehicle for Local Government Pension Schemes (LGPS) investors.

A RIF(CS) could be a similarly useful vehicle allowing exempt treaty eligible investors access to best available treaty rates but with an added benefit of access to a wider range of assets outside of the permittable investment restrictions of an ACS structure. Currently, many LGPS investors use Exempt Unauthorised Unit Trusts (EUUTs) to access these types of assets, even though they are not the most efficient vehicle, due to the lack of available UK fund structures in this space. An unauthorised structure like the RIF(CS) would allow for a variety of investment strategies delving deeper into a range of asset classes and could potentially be attractive for instance to LGPS investors.

4. Do you foresee any legal or administrative issues with the proposed eligibility criteria? Would you recommend that the government include additional requirements for an unauthorised co-ownership contractual scheme that wishes to become a RIF? If so, please explain the reasons for this.

Please see our response to Question 2. Additionally, to help manage the risk of a fund accidentally falling out of the regime, the eligibility criteria should not be set up as cliff-edge tests and instead allow for remedial actions, recognising temporary breaches similar to that available in other parts of UK tax legislation. We do not consider introduction of any further requirements to the eligibility criteria.

5. Are there are there any are specific tax provisions that should be considered to facilitate RIF investment in asset classes other than real estate?

The VAT treatment of a fund is an important factor while considering the location and structure of the fund vehicle.

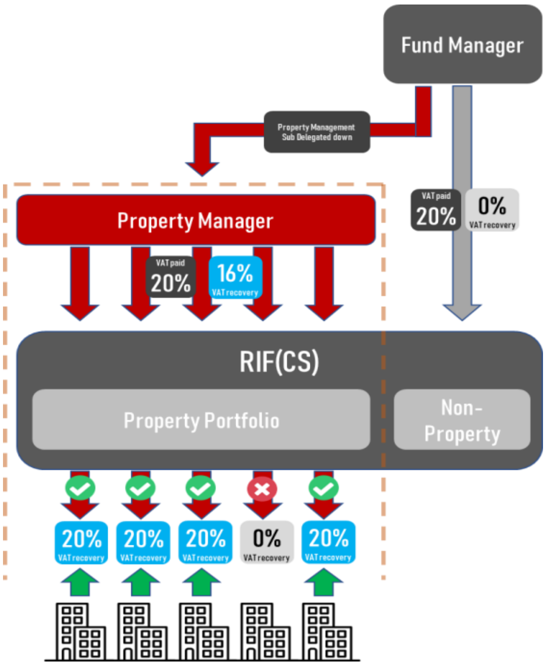
The consultation states that the VAT treatment of management of RIF(CS) should be the same as the management of other funds. However, while not explicit, the language used in the consultation, read in conjunction with the proposed principle-based criteria for funds benefitting from UK VAT fund management exemption in the recent **VAT in Fund Management consultation**[1]**,** implies that a RIF(CS) as an AIF vehicle is unlikely to be classified as a Special Investment Fund ('SIF'), due to it not being a UCITS product. If this were the case, the RIF(CS) will not be able to access the UK fund management VAT exemption and in absence of any other relief, the supply of management services will be standard rated at 20%. This treatment is indeed contrary to the VAT treatment of other UK funds, listed in Schedule 9 and 10 of Group 5 of the VAT Act 1994, in particular Authorised Contractual Schemes (ACS).

While the VAT position may be manageable for funds with investments only in commercial real estate on the basis of the fund being able to opt-to-tax the underlying properties for VAT purposes and thereby reclaiming input VAT charged on management fees in respect of such property, this treatment effectively renders the product far less attractive for other investments beyond commercial real estate, (e.g. residential property).

The IA disagrees with this approach and the resulting outcome. Given the extensive litigation in this space and ignoring the fact that the proposed principles-based criteria are still under consideration by the Government, **fund managers are likely to be unwilling to risk trying to exempt either all or partial supplies of fund management to RIF(CS) without clarity from the Government**.

This approach will put the RIF(CS) at odds with ACSs, making ACS to RIF(CS) conversions less likely, and will mean for almost all possible asset classes, except for certain commercial real estate, investors will suffer the VAT cost on these fees.

Real estate investments. Even for funds that can opt to tax some of their commercial investments, we illustrate below practical considerations that would apply.



In this example the operator of the RIF(CS) will delegate down to a property manager management of the fund's property portfolio.

The RIF(CS), under the operator, will be able to register the fund for VAT. At which point it can begin to choose which properties it wishes to Opt to Tax.

For every property it opts, it must charge VAT on the supplies provided (rent charged and the sale price) but it will be able to then recover any VAT costs associated with making those supplies.

In a diagram here, the fund opts 4 of 5 equal properties and can recovery 4/5s of the VAT charged by the Property Manager.

The registration for VAT and opting of properties can take a considerable period of time.

While HMRC aims to turn around standard registrations within 40 days, complex Partial Exemption Special Methods can take considerably longer, dragging on for months if not years after the application is first made.

1 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1122855/221130_VAT_on_fund_management_condoc.pdf

Bifurcation of Management Fees. It is also important to understand that it is not uncommon for fund operators to seek to have distinct compartments within funds - managed separately, sometimes by more than one delegated manager.

For property funds in particular the supply of management services is often split between the operator whose focus is on the fund's liquidity while a dedicated property agent is appointed to manage the bricks and mortar property assets. Many property funds will mix and match their property exposure through direct property and indirect holdings of property-rich assets which themselves invest directly in property.

Under the RIF(CS) any management fee attributable to non-property will attract 20% VAT.

It is likely that this will hinder RIFs from offering mixed investment strategies including many popular methods of gaining exposure to UK property such as:

- UK REITs
- UK PAIFs
- Qualified Asset Holding Companies (QAHC)

The last of these is particularly unedifying as it will mean that there will now be a strong incentive effect for operators of RIF(CS)s to avoid utilising the UK's new premium Special Purpose Vehicle.

Closed-Ended RIF(CS). The VAT treatment is also likely to put pressure on open-ended RIF(CS)s that operate UK property portfolios.

Traditionally open-ended property funds have had to maintain and manage a significant portfolio of cash or near-cash assets to protect against market downturns and waves of investor redemptions. As an example, many UK PAIFs will hold between 15%-35% in assets such as UK gilts and US treasury bonds to meet the fund's liquidity needs.

VAT on managing these cash-like assets will increase the cost to the RIF(CS) and as a result its investors. The higher percentage of the portfolio made up of near-cash, the higher the VAT cost compared to other competing fund types. It is entirely possible that in an attempt to sidestep this balancing act of cost vs liquidity management, managers may simply limit their RIF(CS) offerings to close-ended vehicles.

Our proposals:

VAT Zero-Rating. In line with the IA's long-standing asks, for the UK to truly materialise the potential of its fund vehicles, it must consider introducing a VAT zero-rating for the management of all UK fund vehicles including the RIF(CS) putting it at par with the VAT treatment of UK management of comparable non-UK vehicle. VAT zero-rating of fund management to an RIF(CS) would be transformational and open up the RIF(CS) to invest in every conceivable asset class.

Option to Tax. Alternatively, while VAT zero-rating is considered more widely, we propose that RIF(CS) should be included in VATA 1994 Schedule 9, Group 5 item 9 as VAT exempt with the introduction of an option to tax at a fund level for RIF(CS) funds, similar to that offered at investment level, allowing it to elect into taxation depending on its investment strategy and investor profile. This approach would likely open up the RIF(CS) as an attractive option for a wide variety of investments beyond purely commercial real estate.

6. Do you foresee any issues with the government's intended requirements for reporting income to investors, or with replicating the provisions related to excess reportable income arising to RIF investors from an investment in an offshore fund?

We have no disagreements on the principles that a RIF(CS), like an ACS, should factor down any excess reportable income to its investor pool.

We would however comment that, given our response to Question 5, we believe it is exceedingly unlikely that a RIF would seek to employ a mixed investment strategy to include investments in offshore funds – reporting or otherwise.

7. Should RIFs be added to the list of permitted property categories at section 520 ITTOIA 2005 and do you consider that the structure and nature of RIFs means that individual policyholders would be effectively prevented from introducing personal assets into their life insurance policy?

We have no comments at this time.

8. Do you have any views on the proposed capital allowances treatment?

We understand the capital allowances treatment broadly mirrors that of other transparent vehicles, including JPUTs.

Any look through apportionment, either by the investor or the operator, is likely to only be a consideration for investors which can themselves utilise them.

Members have also commented that the treatment of capital allowances should a RIF(CS) fall out of the RIF regime would be nearly impossible to compute for even a moderate portfolio of properties. Investors reliant on the allocation of capital allowances will then be wary as to the risk of the RIF(CS) losing its RIF status.

9. Do you have any general comments on the proposed capital gains treatment of investors in a RIF, subject to the detailed questions in Chapter 4?

We note as part of para 3.22 that the government intends to introduce a form of protect cell treatment to insulate each sub-fund within a RIF(CS) umbrella structure. This is now a standard feature of almost all international collective investment. We support this measure.

Providing this treatment to non-RIFs is crucial as it would address additional concerns related to RIF(CS) leaving the RIF regime. Without such a measure, losing the RIF status would become even more punitive, which may discourage potential investors who rightfully hesitate to mix liabilities under the same umbrella.

Please also see our comments to question 19 in respect of breaches. The risk of an exempt fund changing its status to transparent, in this instance for capital gains purposes, could be a significant red flag for investors and deter them from investing in such a product.

10. Do you have comments on the proposed capital gains treatment for insurance companies?

We have no comments at this time.

11. Would this proposed rule help facilitate a RIF's investment in REIT? Would any further tax provisions be required to further facilitate a RIF's investment in other property funds?

We have no comments at this time.

12. Would the proposal outlined here be a viable option to achieve fair SDLT treatment of property acquired by and held by unauthorised co-ownership contractual schemes, whether or not they are within the RIF regime?

We agree that unauthorised co-ownership contractual schemes (whether qualifying as a RIF(CS) or not) should be treated as opaque structures for SDLT purposes, replicating the provisions for CoACS under Section 102A Finance Act 2003.

13. Are there any features of the existing CoACS seeding relief that are unsuitable to be applied to RIFs?

The seeding relief thresholds of £100m and 20 commercial or 100 residential properties are too high and should be lowered for a RIF(CS) to help promote investor interest in the fund.

14. The length of the control period for PAIF and CoACS seeding reliefs is three years. Would a similar period be appropriate for RIF seeding relief claims?

We have no comments at this time.

15. Do you foresee any issues with the proposed Stamp Duty or SDRT treatment?

We have no comments at this time.

16. Do you have any comments on the VAT treatment of the management of a RIF?

Please see out detailed comments in the response to **Question 5.**

17. Are there any circumstances other than that outlined in paragraph 4.11 that the government should be considering to ensure that the RIF tax regime aligns with the government's policy of taxing non-UK resident investors on gains on disposals of UK property?

We can see no additional risk to the government's policy of taxing non-resident investors beyond what has been set out in Chapter 5.

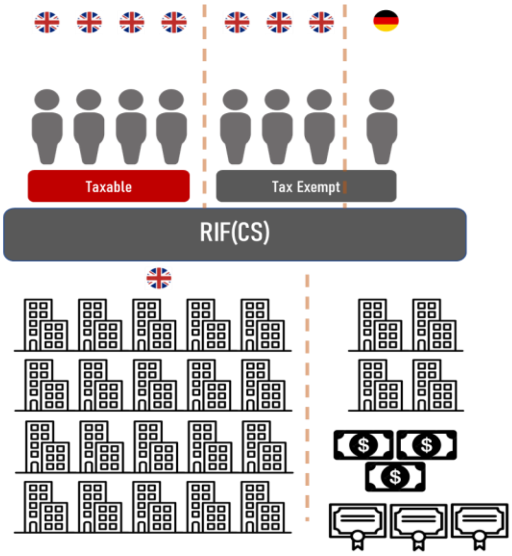
18. Would take-up of the RIF be affected, and if so to what extent, if section 103D TCGA was disapplied where a restricted RIF breached a restriction? Are there alternative ways that a breach could be dealt with?

From member feedback we believe that take-up of the RIF(CS) will be heavily influenced by any risk of a RIF losing its status and investors suddenly being exposed to capital transparency. This risk is far more manageable and less risky for RIFs targeted purely at capital gains tax-exempt investors. In the other two scenarios, however, where at least 75% of the value of the RIF's assets must be derived from UK property ('always UK property rich') and where the fund should not directly invest in UK property or in UK property-rich companies, the risk of accidentally breaching these requirements is higher and could potentially prove unattractive for investors, unless there were measures in place to allow the fund to correct inadvertent breaches and for any penal tax consequence to only apply to relevant investors, not penalising all investors.

Moreover, the consultation proposes that similar to a CoACS, an operator of a RIF(CS) must provide sufficient information to participants in the scheme in relation to each accounting period to enable those participants to meet their tax obligations in the UK with respect to their interests in the scheme.

The requirements combined with the restrictions on scope create operational difficulties which we have illustrated below:

Option 1 – Always UK-Property Rich



In this example there at 8 investors.

All 8 are exempt from NRCG, 4 however are subject to UK tax.

Inadvertently, the RIF(CS) falls below the 75% threshold for being considered UK Property Rich.

This then means that the operator will have to provide Capital Gains information for the 4 UK taxable investors.

At 20 properties this would be 80 separate gains calculations per pricing point.

At 30 different equity securities in the portfolio this is 120 gains calculations per pricing point.

Option 2 – Exempt Investors

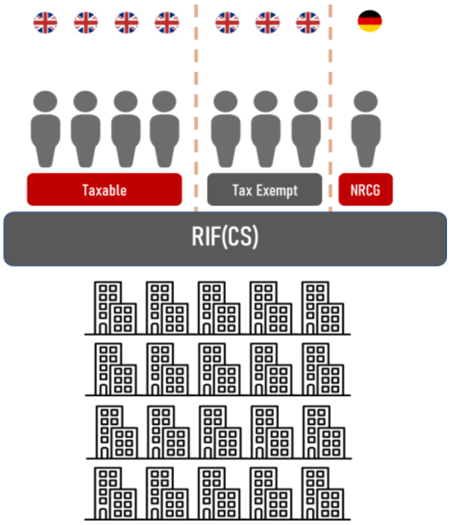
In this example there at 8 investors.

Initially all 8 are exempt from NRCG, 4 however are subject to UK tax.

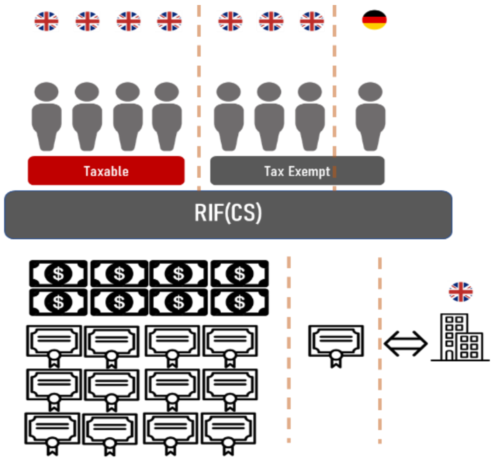
1 investor comes into the charge of NRCG meaning the RIF loses its RIF(CS) status

This then means that the operator will need to provide Capital Gains information for the 4 UK taxable investors and single Non-Resident investor for each individual properties.

At 20 properties this is potentially 100 separate gains calculations per pricing point.



Option 3 – Barred from UK Property



In this example there at 8 investors.

All are exempt from NRCG, 4 however are subject to UK tax.

Inadvertently, the RIF(CS) invests in a security which is either UK Property Rich or is in someway transparent give exposes the fund to the underlying UK property.

This then means that the operator will have to provide Capital Gains information for the 4 UK taxable investors.

At 100 different equity securities in the portfolio this is potentially 400 gains calculations per pricing point.

The examples above obviously scale with the number of properties, securities and taxable investors.

Example 2 uses the 20 commercial property threshold necessary in order for an ACS to qualify for SDLT seeding relief while, as an extreme example, a RIF(CS) with 100 properties for 100 separate investors for an open-ended RIF(CS) that prices daily could mean the operator is obliged to offer 3,650,000 individual gains calculations, and so on.

The point we are pains to emphasis here is that the larger the RIF(CS) becomes both in terms of assets and investors the cost of rectification for the operator grows exponentially. Understandably, potential operators have express deep concerns that such scenarios will quickly become unworkable and even the most sophisticated technological solutions for transparency under the Statement of Practice D12 rules are likely to prove ineffective. Feedback suggests that across the UK currently no operator offers more than a limited service in this space covering a handful of properties for a handful of partners.

These concerns obviously spread to the investors themselves who will be affected by the loss Section 103D TCGA 1992 should a RIF(CS) lose its RIF status. ACSs for example have proven popular within the Life Company space, however feedback suggests that they will have little to no interest in comingling investment should they be exposed to the possibility of a deemed disposal of units.

19. What, if any, legislative or administrative easements would be required for unintended breaches by a UK property rich RIF?

Firstly, we would suggest that the term breach is qualified, as it is important to recognise that not all breaches will result in a loss of tax revenue for the UK. Additionally, temporary breaches, such as during initial launch period and wind downs, as well as any minor breaches need to be recognised and allowed to be rectified without the fund permanently losing its RIF status, particularly recognising the illiquid nature of real estate and many other alternative assets.

There may be other easements which could be offered to the RIF(CS) and we would we keen to engage with HM Treasury and HMRC as the secondary legislation around the regime is built to ensure these are targeted and effective.

20. To what extent would such restrictions on a RIF's ability to invest more than 25% of its total asset value in non-UK property assets limit take-up?

As stated previously, there is likely to be a strong incentive to manage the risk of the RIF losing its exempt status and as such it is likely that funds looking to use this condition for qualification as risk are likely to focus predominantly on UK real estate. Beyond our response re breaches in response to question 18, we do not have any further comments on this question.

21. What commercial appetite would there be for a RIF that was only open to investors who are exempt from tax on gains?

We understand that the RIF is likely to be of interest to pension investors and LGPS pools, provided that the risks of the fund falling out of the regime and the negative consequences of inadvertent, temporary and minor breaches were minimised.

22. Would there be appetite for a RIF that is restricted from investing in UK property?

There may be some interest from certain investors in such a RIF, however, for most part it is likely that investors would choose a vehicle that is well-established, carries less risk, is operationally easy to understand and operate and carries lower VAT costs.

23. Do you have any suggestions about how the base cost of an investor could be computed on a disposal of UK property for a non-UK property rich RIF where the RIF was only transparent for gains at the point of a disposal of UK property or where there was a change of investor?

We have no comments at this time.

24. Do you agree that the RIF would need to be deemed to be a partnership for gains throughout the period it is non-UK property rich to give a basis for capital gains computations if option 2 were applied to a RIF which transitions between UK property rich and non-UK property rich?

We have no comments at this time.

25. **Do you think that applying option 2 to a RIF that transitions between UK property and non-UK property rich could achieve the government's aim of taxing non-UK resident investors on gains of disposals of UK property?**

We have no comments at this time.

26. **Do you consider that there are any more effective ways by which the government could ensure non-UK resident investors in a non-UK property rich RIF are taxed on gains on disposal of UK property? If so, please provide a detailed explanation of how this would work, and the advantages and disadvantages of applying a different treatment.**

We have no comments at this time.

27. **To what extent could difficulties with tax transparency for gains be overcome through the way in which the RIF is structured, for instance using a separate class of units or sub-fund in an umbrella RIF to hold UK property?**

We have no comments at this time.

28. **To what extent would transparency for gains mean that a manager would not in practice choose to establish a RIF to hold UK property where it was not anticipated that the RIF would be UK property rich?**

We have no comments at this time.

29. **Do you foresee any issues with applying similar reporting obligations to a RIF as those that apply to a non-UK CIV that has made an exemption election?**

We have no comments at this time.

30. **Do you have any views on the point from which a RIF should lose its status, if it fails to meet any of the eligibility criteria?**

Please see our comments re accidental, temporary, and minor breaches in response to question 19, requesting a proportionate and considered approach to be taken in such instances.

31. **Do you foresee any issues with the tax treatment of a co-ownership contractual scheme that falls outside both the RIF and CoACS regimes? Should the government consider providing for the treatment of such an unauthorised co-ownership contractual scheme in legislation?**

We have no comments at this time.

32. **Do you have any further views on the viability of the RIF design proposal, not otherwise covered?**

Under the NMMI rules explained in Annex B of the consultation and the requirement for promoters contained in the FCA's COBS handbook at 4.12B, it may be necessary to warn via fund promotional materials, potential RIF investors that they are at risk of negative tax impacts through the status or behaviours of other investors or the performance of the operator of the RIF.

This may necessitate new and additional disclosures to adequately explain to investors that the risks presented within a RIF(CS) are fundamentally different from other Collective Investment Schemes, including the UK's nearest reference point – the ACS.