TRAVERS SMITH

BUDGET 2008
FUNDS TAX UPDATE

This note is Travers Smith's take on the measures in the Budget that are relevant to fund structuring. From a funds perspective, it was a fairly meaty budget.

Non-domiciled investors

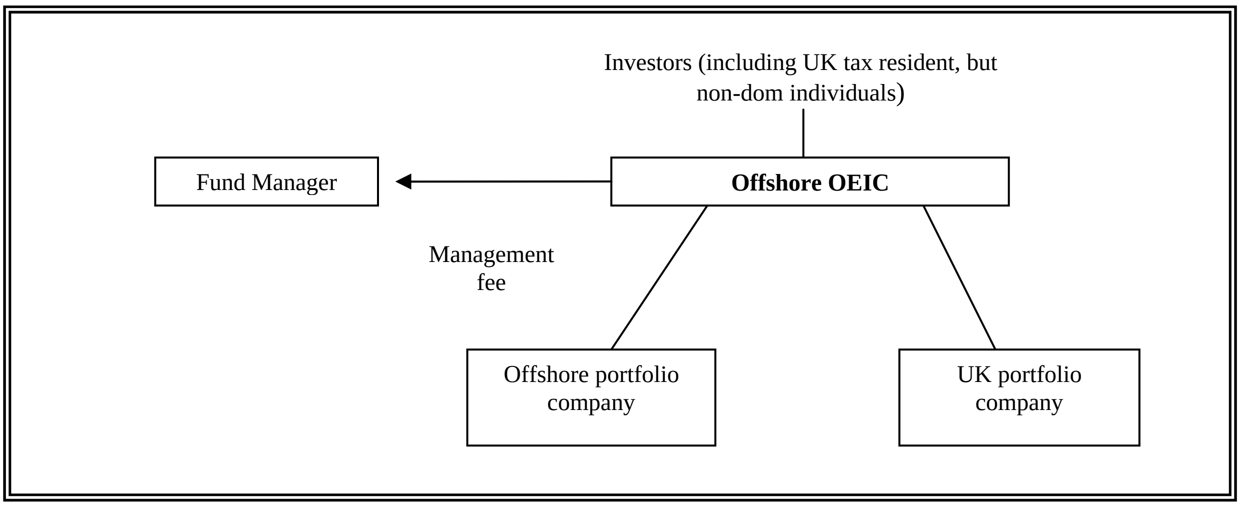
The proposed tax treatment of UK resident non-domiciled individuals ("**non-doms**") has been the subject of heated discussion, but there has been little focus on what this means for funds (this note only covers non-doms issues to the extent relevant to funds). To date, non-dom investors have used their own offshore vehicles (typically offshore trusts) to invest in funds and avoid remittance. The draft legislation published in January severely prejudiced the continued use of offshore trusts. The Budget announcements represent a significant climb-down from the line taken in January. Many non-doms are likely to continue to invest in offshore funds through their offshore trusts.

The new rules define remittance broadly and so non-dom investors are likely to ask more questions about the fund structuring itself and whether making an investment in, receiving distributions from or realising gains through a fund will constitute 'remittance'. The issue is far from clear. There have been a number of changes to HMRC's position and even after the publication of the Finance Bill (likely to be only days before the rules commence on 6 April) it may take some time for the new regime to bed-down and for HMRC's approach to the rules to emerge.

Below, we apply the new rules (so far as they are known) to three typical fund structures – an offshore open-ended investment company (an "OEIC"), an offshore partnership and an English limited partnership. We have assumed that a non-dom investor will invest using amounts which would be taxable if remitted to the UK, but funds should be aware that non-doms may have access to pre-April 2008 gains which they may be able to invest in a UK fund or an offshore transparent fund which holds UK assets without the act of investment itself being a taxable remittance. Funds will have to consider how far, if at all, they will take steps to accommodate non-dom concerns and will want to look closely at whether the fund would be protected from a claim by a non-dom investor if, despite its structuring, an act of the fund resulted in a remittance.

Offshore open-ended investment company

Structure: OEIC incorporated and tax resident offshore making world-wide investments (including in the UK). Could be managed offshore or from the UK.



Investing in the fund

Assuming that the non-dom will not bring his share of returns from the fund into the UK, then - in relation to remittance — the offshore OEIC structure is fairly robust. The non-dom investor's subscription monies should be received and held by the OEIC in an offshore bank account so that subscribing for shares in the OEIC should not constitute remittance.

Acquisition of UK assets by the fund

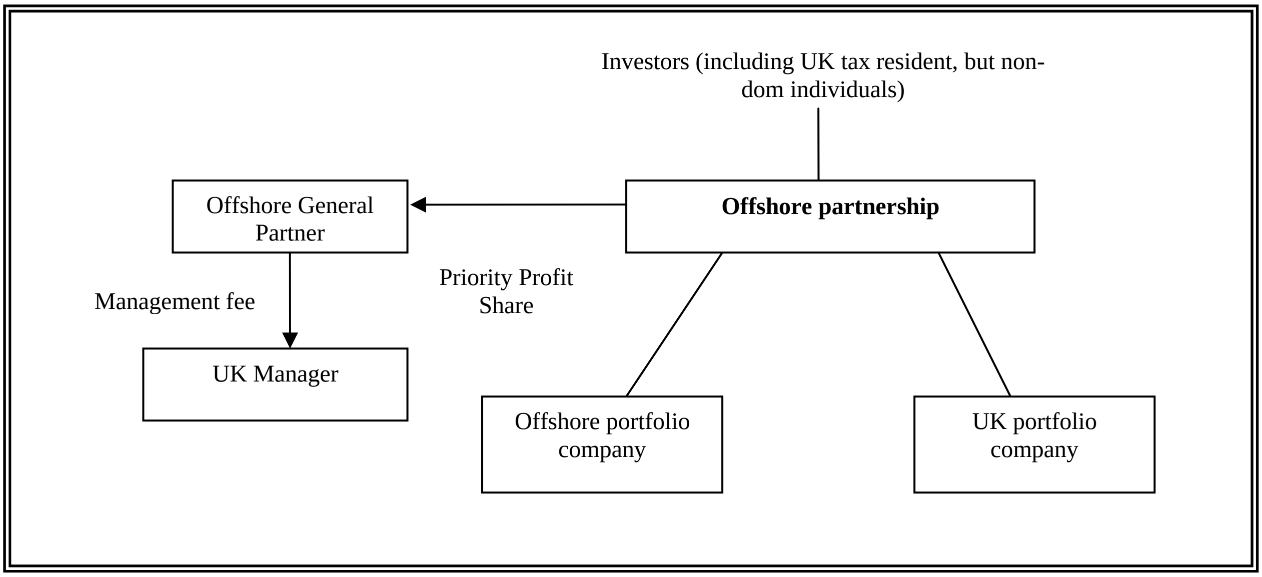
What if the non-dom's subscription monies are applied by the OEIC to acquire shares in a UK company? (There should be a geographical spread of fund assets because the use of an offshore company to invest primarily in the UK may fall foul of UK anti-avoidance legislation). The definition of remittance includes money being 'brought to, received or used in' the UK and this may occur on the acquisition of UK shares. However, the 'bringing to' the UK has to be for the benefit of a 'relevant person'. Where the fund is widely held the acquisition of UK shares by the OEIC should not constitute remittance by its non-dom shareholders.

Returns from the fund

The general rule is that distributions paid by the OEIC to a non-dom investor and any gain arising on the redemption of shares in the OEIC by the non-dom should be taxable on the remittance basis even if the amounts paid by the OEIC to the non-dom are attributable to returns from a UK portfolio company. This is subject to certain special rules. Firstly, if the OEIC is close not widely held, gains realised by the OEIC on the disposal of the UK assets may be attributed to and taxed in the hands of non-dom investors on an arising basis. Secondly, if the 'transfer of assets abroad' rules apply to the non-dom's investment in the fund (because there is or is deemed to be a tax avoidance motive) the non-dom's share of the OEIC's UK source income will be taxed on an arising basis. Finally, if the non-dom realises an 'offshore income gain' on the redemption of his shares in the OEIC the applicable tax rules may depend on whether the investment by the non-dom has been made through an offshore company or an offshore trust and, if the latter, on the timing of capital payments made by the trustees – this is a complex area on which non-dom investors will, no doubt, seek their own detailed advice.

Offshore partnership

Structure: partnership established offshore, not governed by UK law with offshore general partner and UK manager.



Investing in the fund

As with the offshore OEIC, if a non-dom invests in an offshore partnership using previously unremitted income or gains this should not, in itself, constitute remittance assuming that the fund holds the subscription monies in an offshore bank account.

Acquisition of UK assets by the fund

If the fund uses the non-dom's subscription monies to acquire shares in a UK company, then this is likely to constitute remittance particularly if the seller of the shares requires payment in the UK. Even if the transaction can be structured so that the consideration is paid into an offshore bank account for the seller, there must be an argument that the non-dom has 'received' property in the UK by virtue of acquiring, through the tax transparent partnership, UK-situs shares. This will be the case whether the non-dom has invested in the fund directly or through a offshore trust to which he has provided unremitted gains or income and in relation to which he or his family are beneficiaries.

A non-dom investor's share of any dividends paid by the UK portfolio company to the fund will be taxed on an arising basis although it may be possible to preserve the remittance basis of taxation in relation to gains realised by the fund on the sale of shares in a UK company if the non-dom has invested through an offshore trust. Depending on the make-up of the fund's investor base, partnerships may want to give careful thought to the structuring of their UK investments and whether the acquisition of UK assets will constitute remittance. Offshore holding companies may be an answer, but bring with them their own tax structuring issues.

Paying UK management fees

In the early years of the partnership, the general partner will draw-down interest free loans from investors to fund its priority profit share and will use this to pay the management fee. If the amounts drawn-down from non-dom investors represent their previously unremitted income or gains, will use of these amounts to pay a UK manager constitute remittance?

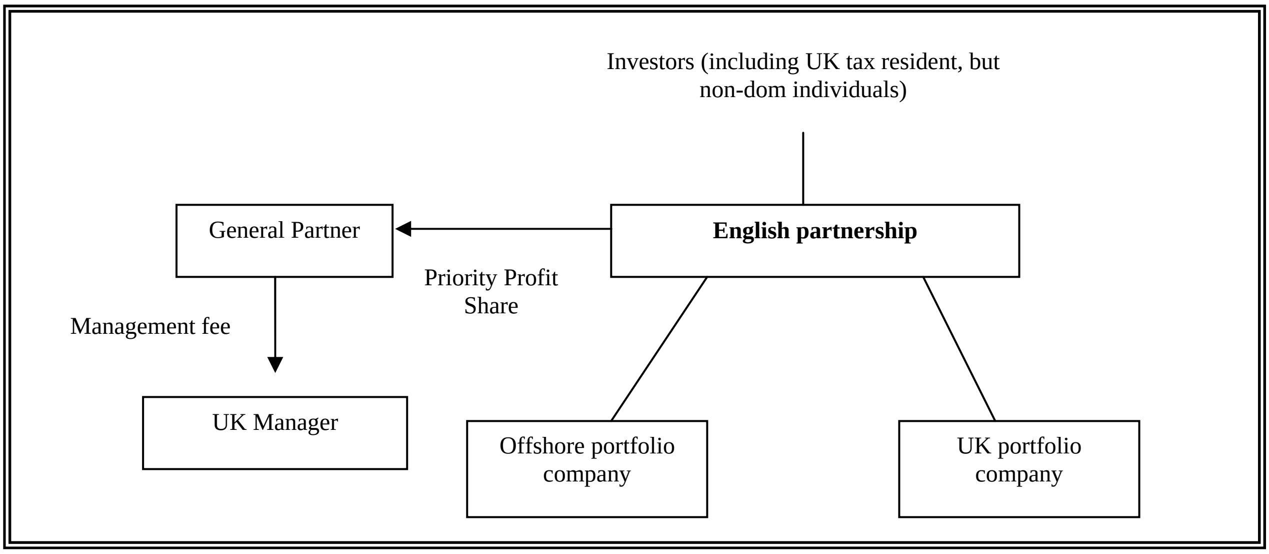
The answer is – possibly.

The definition of remittance includes the provision of services in the UK to or for the benefit of a relevant person. The analysis of whether any service is provided in the UK raises a series of questions:

- who is the relevant person? Both the non-dom and his offshore family trust are likely to be caught. The draft legislation published in January would have extended the definition to the other partners in the fund, with potentially far reaching consequences. After representations to HMRC (including from Travers Smith) it looks as if the Government has stepped back from this position.
- are UK investment management services provided for the benefit of all the partners in the fund or just for the benefit of the general partner? This may depend on the drafting of the fund documents. It remains to be seen what HMRC's approach to services provided to investment partnerships will be, but there must be a risk that it will not want to distinguish between investment management services provided directly to a non-dom and services he accesses indirectly through a transparent collective investment vehicle.
- where are investment management services received? Is it where the manager is based, where the investor is based, where the assets under management are situated or does it depend on where the manager could be sued if it breached the management contract?
- alternatively, is there an offshore manager to the fund who receives advice from a UK-based investment adviser? The adviser may be providing UK services, but the person who benefits from this advice is, arguably, the offshore manager and not the fund. The benefit to the non-dom investor may then be too indirect for the payment of the advisory fee to constitute remittance. Ultimately, this may depend on what actions are taken offshore and whether the offshore manager takes decisions offshore – if so, the UK advisory services are provided for the benefit of the offshore manager which then provides its own (offshore) management services to the fund.
- what if the general partner itself is a UK company (as would typically be the case for an English limited partnership)? In the early years of the fund the general partner's priority profit share is funded by drawing-down investor commitments. Could HMRC argue that a UK general partner is providing a service for the benefit of the other partners in the partnership in exchange for his priority profit share? Typically, the priority profit share is structured as an entitlement to share in the profits of the partnership and not as a fee for services provided by the general partner and – to-date – HMRC has accepted this. There is case law and statutory authority for the view that a partner cannot be remunerated for acting in respect of partnership business and, so far, this has prevented HMRC from re-characterising the priority profit share as a payment for services, but – going forward – care should be taken in drafting the allocation clauses of partnership agreements to make this argument as robust as possible.

English limited partnership

Structure: partnership established under English law. UK company acts as the general partner and UK company or LLP acts as fund manager. A UK partnership is an attractive vehicle, particularly for private equity funds.



Many of the issues discussed above in relation to offshore partnerships also apply to investments made through an English partnership, but the additional question arises of whether the act of investing in an English limited partnership constitutes remittance in its own right.

Investment in the fund

A fund which is set up as an English limited partnership will have to take steps to ensure that an investment by a non-dom does not constitute remittance in itself. The partnership bank account should be offshore so that amounts subscribed to the partnership and amounts received by the partnership from or in respect of its investments are not treated as received in the UK. If it invests in UK assets then the position is as described above.

Capital gains

Where an English partnership disposes of an asset, the Taxation of Chargeable Gains Act 1992 ("TCGA") tells us that each partner is treated as if they had disposed of their share of that asset directly. If the asset is situated outside of the UK then this is taxable on the remittance basis in the hands of non-dom partners: it is irrelevant that the gain passes through an English partnership before it is distributed to investors (provided – as mentioned above – the partnership receives and retains any such amounts offshore). If the asset is situated in the UK gains attributable to non-dom investors will be taxed on an arising basis, but non-dom individuals may be able to shelter these gains from the arising basis of taxation by investing through an offshore trust.

Income

In relation to income realised by a UK partnership from non-UK sources the position is less straightforward. In principle, a partnership ought to be transparent for income tax purposes as it is for capital gains tax so that if, for example, the partnership receives a dividend from a non-UK company each investor will be treated as if he had received a proportion of that foreign dividend directly. The remittance basis of taxation should then be available provided, of course, that the income is retained offshore. The mere legal framework for a partnership should not alter the source of the income received through it. However, the remittance regime includes a separate set of rules for income generated by a trading partnership. This income is taxable on the remittance basis only to the extent that any offshore trading activity is managed and controlled overseas. Although these provisions were, historically, introduced to deal with trading partnerships they have, in recent years, been extended to cover other businesses carried on in partnership and this could include investment businesses. Our view is that HMRC should accept that an investment partnership is transparent for tax purposes and allow income from offshore investments to be taxed on a remittance basis even if the fund is managed in the UK. Having said this, we are aware that others take a different view and – given the uncertainties with the new non-dom regime – funds using an English partnership model may want to consider how they can make their structure as robust as possible. We believe that HMRC will have to clarify this point. However, it may be that income arising from the fund is low or that all returns are made in the form of capital as a result of offshore holding company structures. Much may depend on the structure of the particular fund.

The offshore funds rules

The offshore fund rules prevent investors rolling-up their income offshore and extracting returns in the form of capital. The existing rules apply to offshore funds to the extent that an investor in that fund has, at the time of investing, a reasonable expectation that he will be able to realise his interest within seven years. Funds can take themselves out of the offshore funds regime by applying for 'distributor status' (available to funds which, broadly speaking, distribute 85% of their income each year), but if an offshore fund is caught by the rules and does not apply for distributor status in any year in which an investor holds his interest then its UK resident investors will be subject to income tax and not capital gains tax when they realise their interest in the fund.

The change in the rate of capital gains tax from 6 April 2008 will make securing capital gains tax treatment more desirable for investors. The flip-side of this is, of course, that HMRC will want to clamp-down on products that roll-up income but deliver a capital return. In this context, funds may want to consider the Budget proposals for tax credits to attach to dividends from overseas companies paid to UK resident individuals. From 6 April 2008, individuals holding less than 10% of the shares in the offshore company will be entitled to a non-payable tax credit of 1/9th of the distribution, lowering the effective tax rates on such dividends to 0% (for basic rate taxpayers) and 25% (for higher rate taxpayers). This will be extended in 2009 to individuals who are 10%+ shareholders provided the source jurisdiction levies a tax similar to corporation tax (further details of this condition are not yet available). This may give some flexibility to funds who cannot deliver a capital return to UK investors to think about whether they could deliver returns to investors by way of distribution rather than redemption: both taxed as income, but with the dividend taxed at a substantially lower rate (25% rather than 40%).

We have explained HMRC's proposals for change in this area below. However, these changes will now be deferred as follows:

- the Finance Act ("**FA**") 2008 will contain enabling provisions to allow regulations to be introduced in relation to "Reporting Funds";
- changes to the definition of offshore funds will be contained in FA 2009 which means fundamental change will not occur before 2009/10 and may not be introduced in the form described below. Lobbying works!

What is an offshore fund?

Following changes in FA 2007, an offshore fund includes any collective investment scheme established outside the UK:-

- which owns property/invests funds with the aim of spreading risk and giving members the benefits of fund management; and
- in relation to which a reasonable investor would expect to be able to realise his investment on a basis calculated wholly or partly by reference to NAV.

An investor is caught by the regime if it could be reasonably expected that he could realise his share of NAV within 7 years.

The modifications in FA 2007 caused considerable concern, because they resulted in closed-ended structures with a likely shelf-life of less than seven years being caught. Previously, the accepted view was that only open-ended vehicles were caught. After lobbying, HMRC published guidance to exclude limited-life closed-ended companies although it has become apparent that HMRC consider that funds designed to roll up income and provide a "total return" ought to be with the offshore fund regime.

The Treasury subsequently consulted on a new regime. It proposed to do away with the definition set out above and to adopt a 'characteristics' approach. This would catch a fund if it:

- was created under foreign law and was not UK tax resident;
- was subject to fund management so that investors did not have day-to-day control over the management of the fund's property;
- created rights in the nature of co-ownership;
- aimed to spread investment risk; and
- entitled investors to realise net asset value on their exit from the fund.

As part of this proposal, transparent and semi-transparent funds would be expressly excluded (so that unit trusts constituted as 'Baker Trusts' would no longer have to go through the administratively burdensome process of applying for distributor status).

However, the characteristics based approach would apply equally to closed-ended and open-ended vehicles. This is an area to watch very closely for future development. It may be that guidance will again exclude certain closed-ended structures or it may be that closed-ended limited-life companies are the kind of capital gains tax structure that HMRC will target going forward if used as a 'wrapper' for otherwise income yielding investments. There may also be no 'seven year' or period test. Under the Treasury's original proposals it did not matter *when* an investor expects to realise his interest – the only question is whether he is 'entitled' to receive net asset value. An investor in a fund with regular redemption dates will have such an entitlement, but it is considered that 'entitlement' is a higher test than the current 'reasonable expectation' test and going forward, this may provide some room for manoeuvre. This is again an area to watch closely in the coming months, but for now the choices have been postponed and are subject to future consultation.

The 'Reporting Fund' regime

What will be resurrected prior to 2009 are the Treasury proposals for a new reporting funds regime. We summarise the proposals below, but they may be subject to further change.

An offshore fund caught by the rules can elect to be a 'Reporting Fund' which replaces the current concept of a distributing fund. If it makes such an election, UK investors will be entitled to capital gains tax treatment when they realise their investment. If an offshore fund is a non-reporting fund, UK investors will be subject to income tax on exit instead.

Unlike distributing funds, Reporting Funds are not required to make a physical distribution of their income to investors, but a Reporting Fund must report all (and not just 85%) of its income to investors each year. UK tax resident investors will then be subject to income tax or corporation tax on this amount as if they had received a distribution. This does allow some flexibility: for example, the current requirement to physically distribute 85% of income makes the reinvestment of dividends cumbersome, but if no distribution is made UK investors will face an unfunded income tax charge on the income reported to them.

What about funds of funds?

If a Reporting Fund (the "Fund") invests in another fund (the "Sub-Fund") which is also a Reporting Fund, the Fund must report the income reported to it by the Sub-Fund to its investors as if it had arisen to the Fund directly.

If the Sub-Fund is a non-reporting fund, then the Fund has two choices. If it has access to detailed information about the Sub-Fund's income and gains, it can treat the Sub-Fund as a Reporting Fund and report its income to the Fund's investors. If the Fund does not have access to this information, it must 'fair value' its investment in the Sub-Fund i.e. must report the increase in fair value over the previous year to investors. The amount of the increase will then be taxed in the hands of UK resident investors as if they had received a distribution from the Fund. This 'fair value' requirement was proposed to also apply where the Fund invests in a 'bond fund' (as defined in paragraph 8, Schedule 10 Finance Act 1996) which we consider to be technically wrong as this charge is currently limited to corporation tax. The fair value rule may be problematic for investors who will face an unfunded income tax charge on movements in value which may be impossible for the underlying funds to distribute and which may not represent accruing income at all. If the fair value of a Sub-Fund drops, there was no proposal to allow this 'loss' to be set against income tax on increases in value in previous or subsequent years. All these proposals produced comment.

Obtaining Reporting Fund status

To elect to be a Reporting Fund, an offshore fund must submit certain information to HMRC – such as its prospectus and audited financial statements. It must also be able to demonstrate that the fund has a genuine commercial purpose and that the main purposes of the fund is not the deferral or avoidance of UK taxation. The anti-avoidance test seems totally unnecessary: it is hard to see how a fund which is effectively transparent for income tax purposes could be used as a tax avoidance vehicle.

Changes to the Investment Manager Exemption ("IME")

The revised statement of practice on the investment manager exemption (revised SP1/01) was published in July last year. Throughout the consultation exercise leading up to the new statement, HMRC made it clear that it also wanted to amend the meaning of "investment transaction" but this could not be dealt with in the statement – it required legislative change. The pre-Budget Report had suggested that measures would be introduced to align the definition of 'investment transaction' more closely with the definition in FSMA.

The Budget announcement makes no reference to FSMA. Instead HMRC will publish a single list (not yet available) of investment transactions which qualify for the IME. HMRC will also have power to update the list without the need for further legislation. The new approach is welcome (although just how welcome will obviously depend on which transactions are in and which are left out).

Also helpful is the removal of what had become known as the 'cliff-edge'. It is currently the case that if a UK investment manager carries out a transaction on behalf of the fund which is not a permitted transaction for IME purposes, the benefit of the IME is lost and the offshore fund or – if a transparent fund - its non-resident investors, are subject to UK tax as if the manager had always been their UK permanent establishment. Going forward, qualifying transactions will continue to fall within the IME and only the non-qualifying transactions will be exposed to UK tax.

Change of practice on the contribution of assets to a partnership

In January this year, HMRC published business brief 03/08 which announced a change of practice (although not acknowledged as such by HMRC) in relation to the contribution of assets to a partnership.

Statement of Practice "D12" provides that, on a change in partnership sharing ratios, the partner who gives up or reduces his share will be treated as making a disposal of his share of the partnership's assets on a no-gain/no-loss basis if the assets of the partnership are held at cost in its books and have not been revalued. D12 is silent on the position of an incoming partner who contributes a capital asset in connection with his admission to the partnership, but historically HMRC has consistently extended D12 to cover this situation too. In practice, the contribution was therefore deemed to be made on a no-gain/no-loss basis too, regardless of the amount credited to capital on the contribution of the asset.

Business brief 03/08 states that this is no longer HMRC's position. The contribution of an asset to a partnership will no longer be treated as a no-gain/no-loss disposal, but as potentially giving rise to a chargeable disposal by the incoming partner. The disposal will be of the fractional share of the asset given away and the consideration will be the same proportion of amount credited to the contributor's capital account. The new rules can have unintended results where assets are contributed to an existing partnership the assets of which have a value in excess of cost. Of concern is that HMRC intend that the new approach will be applied retrospectively unless the contributing partner had obtained comfort in writing from HMRC.

It may still be possible to contribute an asset to a partnership without triggering a chargeable gain. If the only 'consideration' received by the incoming partner is his entitlement to an interest in the partnership, then provided the partners are not otherwise connected and the transaction is at arm's length whether or not a tax charge arises will depend on the amount credited to the partner's capital account. Where the capital account reflects the incoming partner's base cost in the asset it is considered that a tax charge should not arise, but a partnership will need to consider whether this is achievable in accounting terms and whether it is commercially desirable (if the asset stands at above cost the difference could be paid to the contributing partner if, say, the asset were sold; but this has different commercial consequences). Contributions of this type now need to be handled with care and with the accounting in mind.

Abolition of taper relief

As expected, taper relief has been abolished. It has been replaced with 'entrepreneurs' relief' with an effective 10% rate of tax for an individual's first £1 million of gain and then a flat rate of capital gains tax of 18%.

For carried interest holders in private equity funds, entrepreneurs' relief is unlikely to apply on the fund's disposal of the shares in its portfolio companies. There are three tests. The portfolio company must be a trading company or the holding company of a trading group. The carried interest holder must hold at least 5% of the ordinary share capital and 5% of the voting rights and must be an employee or office-holder of the portfolio company. The 5% tests and the employment test must have been satisfied for the year prior to disposal.

Even for carried interest holders who sit on the board of the appropriate portfolio company, entrepreneurs' relief is unlikely to be available because of the requirement that the ordinary share capital of the portfolio company must be 'held by' the individual and that 5% of the voting rights in that company are 'exercisable by' the individual. Typically, shares held by a fund will be held and voted by the general partner of the partnership and not by individual investors. There is a provision in the draft legislation that explains that, where shares in the company are held 'jointly' or 'in common with one or more other persons', the individual is treated as holding such number of shares as is proportionate to the value of the individual's share. However it is not considered that this is meant to extend the meaning of 'held by' or votes being 'exercisable by' to holdings through partnerships.

Entrepreneurs' relief aside, private equity fund managers will be relieved that the tax chestnut of when the taper relief clock started to run in respect of their carried interest is no longer relevant. The new 18% rate of tax requires no minimum holding period.

Small companies rate of tax – change in the meaning of 'associate'

A fund which has been set up as a partnership will typically include a tax paragraph in its prospectus warning investors that investing in the fund may result in the small company's rate of taxation ceasing to apply to companies controlled by that investor. This is because the profit threshold for eligibility for this lower rate is reduced if the company has one or more associated companies. The definition of what is an "associated company" is drafted very widely and can include companies that an investor in a partnership is deemed to control because the legislation attributes all of the rights of the other investors to him. This may result in the withdrawal of the small companies rate for the company that is actually controlled by the investor in question. HMRC has acknowledged that this is an unintended result and legislation will be included in the Finance Bill to amend the definition of control so that, for the purposes of its application to the small companies rate of corporation tax only, the rights and powers held by business partners will be attributed only when "relevant tax planning arrangements" have had effect which aim to exploit the small companies rate.

Venture Capital Trusts and Investment Trusts

The direct tax changes relating to investment trusts and VCTs are minor – namely, excluding investments in shipbuilding and coal and steel production from the relief, because they constitute unlawful state aid for EU purposes.

The VAT changes for VCTs are more significant. The VAT exemption for fund management is to be extended to cover investment trusts and VCTs in relation to supplies made on or after 1 October 2008. Where there is a continuous supply of services, as with VCT management fees, the measure will normally take effect by reference to the first invoice or payment made after 1 October 2008. Managers should check whether their fees are expressed to be VAT exclusive or inclusive. In the unusual event of the latter, the exemption could lead to an increase in the fee (depending on the wording in the contract). The removal of the exemption is not all good news because the manager will have irrecoverable input tax. Some management contracts will contain clauses enabling the manager to recover this irrecoverable input tax in addition to its fee where that irrecoverable tax arises as a result of the provision of services to the fund. If no such provision applies the VCT's costs could reduce and the manager's increase.

With respect to claims for past years HMRC, in response to the JP Morgan Claverhouse Investment Trust case, has stated in Business Brief [58/07] that the Claverhouse case is limited only to investment trusts and accordingly any claims by VCTs for repayment of tax previously paid will be rejected. The question of recovery of VAT which has been overpaid is complex. In very brief terms:

- a claim has to be made by the manager to HMRC;
- HMRC has to be satisfied that the claimant is not "unjustly enriched" (which means that the manager must agree to pay the VAT reclaimed to the VCT);
- HMRC will set-off the managers irrecoverable input tax against the amount claimed; and
- the manager will need to make sure that it is not out of pocket as a result of making the claim – in other words, if there is irrecoverable input tax, it can either reduce the amount paid to the VCT or recover those sums separately from the VCT.

It may be the case that given the exemption will apply going forward, and also given the fact that HMRC are not likely to repay VAT for past periods without a further court case occurring, there is a general acceptance in the industry that no further action should be taken. If any clients are interested in pursuing this matter further, we have prepared sample documents which may be of interest concerning the necessary agreements between manager and VCT relating to recovery and repayment of input tax together with other notes.

Property Authorised Investment Funds ("Property AIFs")

Regulations have been introduced to provide a tax regime for property AIFs, which are basically the UK authorised investment fund equivalent of UK-REITs. Given the current property market, property AIFs are probably unattractive to investors, but if and when the market recovers, they may become an alternative to a UK-REIT. The pricing of units in a property AIF ought to reflect the underlying value of the property, rather than be influenced by changes in market sentiment which often affect the prices of listed shares.

The regime for property AIFs is different from that applying to UK-REITS, reflecting their open-ended nature. Only AIFs which take the form of an open-ended investment company can qualify and to qualify a number of conditions have to be satisfied. A property AIF has to carry on a property investment business (renting property, investing in UK-REITs or their foreign equivalent). Its activities must, as to 60 per cent by reference to both income and assets, be represented by that business by the end of (broadly) its second accounting period, it cannot have any body corporate owning in excess of a ten per cent interest in it, it must not take out any loan where the return is dependent on the results of the business or the value of its assets, and must give notice of its intention that the regulations to apply to it. Distributions from a property AIF are in three streams – distributions of income from the property business, interest distributions, and dividend distributions.

Once within the regime, income and gains from the property investment business are tax exempt in the hands of the entity.

The advantage of property AIFs is that, subject to qualifying under the regime, distributions from the property investment business are treated as income received from real property, subject to deduction of tax. As there is little or no tax in the vehicle property AIFs could be attractive to exempt and taxable investors alike – exempt investors could recover tax deducted from income and taxable investors would receive their share of income subject to deduction of tax to set off against any liability. Redemptions give rise to gains. A distribution from the property business is treated as the net profits of a property business and so a shareholder in a property AIF cannot obtain a deduction for interest on any borrowing taken out to acquire his shares. Furthermore, there is a restriction on the amount of borrowing that the property AIF itself can undertake. The vehicles do not therefore "mimic" very closely direct investment in property. In place of the requirements for UK-REITs that shares be listed, there is a requirement that there is genuine diversity of ownership in a property AIF, which is basically that the shares are to be widely available, marketed, easily acquired, do not bear excessive charges for small investors and do not carry an unnecessary high minimum ownership. These conditions are onerous but advance clearance can be obtained.

The real issue with property AIFs may be entry into the regime. If a UK entity wished to unitise, this would lead to a disposal of its assets so the route available to it would probably be a UK-REIT rather than a property AIF. An existing UK authorised unit trust could convert into a property AIF and there is a regime for conversion without payment of SDLT. However, as there are so few existing property authorised unit trusts in the UK, this route is unlikely. An offshore unit trust could convert into a property AIF, but full SDLT would be payable on the transfer of the properties into the property AIF. This is quite a significant entry barrier to this regime. As the vehicle is open-ended and all income is distributed the proceeds of the redemption of interests are paid without deduction and only subject to capital gains tax in the hands of UK unitholders. This is potentially a more attractive regime than for a REIT.

Funds of Alternative Investment Funds

A new initiative is to be introduced to create a new tax regime for funds of hedge funds. These are described as "funds of alternative investment funds" (FAIFs). Such funds can be established as qualified investor schemes under a new FSA regime. However, the existing UK tax rules do not work very effectively for such schemes because the UK fund which would be established as the FAIF would be subject to the existing offshore fund rules and would suffer tax charges under those rules on liquidating positions in the underlying hedge funds (under UK rules, such a fund would only have an exemption from capital gains tax and not from income tax charges). Accordingly, the new tax regime would exempt such a fund, on an election being made, on tax from offshore income gains but instead the investor in a FAIF would be chargeable solely to income taxes on any gains made on disposal of units in the fund. In other words, there would be an automatic opt-in to income tax treatment for investors UK funds of hedge funds.

Given that hedge fund investments are generally caught by the offshore fund rules currently, this new regime may, to a certain extent, be attractive as it will enable UK tax exempt funds to be established in order to invest in a variety of offshore hedge funds, without the need to set up offshore administrative arrangements which may carry additional costs. The downside is that such structures may not be particularly attractive to overseas or non-dom investors who may distrust the volatility of the UK tax regime and also "lock in" the UK tax charge at the highest UK marginal tax rate.

Travers Smith 10 Snow Hill London EC1A 2AL T +44 (0)20 7295 3000 F +44 (0)20 7295 3500 www.traverssmith.com		**Alasdair Douglas** alasdair.douglas@traverssmith.com +44 (0)20 7295 3203		**Richard Stratton** richard.stratton@traverssmith.com +44 (0)20 7295 3219
		Emily Clark emily.clark@traverssmith.com +44 (0)20 7295 3393		**Joseph Bowden** joseph.bowden@traverssmith.com +44 (0)20 7295 3447

		Rosie McGrigor rosie.mcgrigor@traverssmith.com +44 (0)20 7295 3241		