GOWLING WLG

RIF to be introduced by April 2025

13 November 2024

1. Introduction of RIF confirmed

The 2024 Autumn Budget included confirmation that the Reserved Investor Fund (Contractual Scheme) ("**RIF**") will be introduced by April 2025.

The previous Government had already brought forward enabling legislation for the RIF in Finance (No 2) Act 2024 and released draft regulations for consultation in March 2024 ("**Draft RIF Regs**"). Those regulations provided helpful clarifications in respect of certain aspects of the tax treatment of the RIF but included a number of areas that industry considered problematic.

We expect updated regulations to soon be released by the new Government ("**Updated RIF Regs**") and hope they will take on board feedback previously provided by industry. This article seeks to draw out the key aspects of the Draft RIF Regs and sets out the key changes that we would like to see in the Updated RIF Regs when released.

2. What is a RIF and where does it come from?

The RIF is a "contractual scheme" formed under a contract between the investors in the RIF (who beneficially own the RIF's assets), a Depositary (that owns legal title to those assets) and an Operator (that will manage the assets in accordance with the terms of the contract). The RIF is not an entity and does not have legal personality.

The ability to form a contractual scheme in the UK already exists. The RIF is modelled on the co-ownership authorised contractual scheme ("**CoACS**") which was introduced in 2013, the key difference being that the RIF is not itself authorised by the FCA.

Similar structures exist in a number of other jurisdictions including Luxembourg (fonds commun de placement) and Ireland (common contractual fund).

The RIF was originally dubbed the "onshore JPUT" and the intention behind it was to create a UK fund vehicle that:

- Is fast to market and easier to operate (vehicle itself not regulated).
- Offers flexibility as to the terms of constitutional documents (reduced FCA control).
- Nonetheless provides investors with a degree of regulatory protection (managed by an Authorised Alternative Investment Fund Manager (AIFM) and has a Depositary).

3. Expected Tax Benefits of a RIF

Assuming the relevant conditions are met, the expected tax benefits of a RIF are:

- Transparent for income tax (particularly beneficial to investors with advantageous tax status such as sovereign wealth funds and UK registered pension funds).
- Effectively exempt from CGT.
- No SDLT, SDRT or stamp duty on transfers of RIF units.
- The RIF and not investors is subject to SDLT on property and stamp duty on shares/securities purchased by the RIF.
- Seeding relief on transfers of property (SDLT) and shares/securities (stamp duty) to the RIF in consideration for the issue of RIF units.
- Onshore management.

4. What will a RIF be used for?

We can see a variety of usage cases for the RIF and consider that it could be a strong addition to the UK's funds arsenal. For example:

- Existing CoACS may consider moving away from authorised status if that fits with their strategy and investor base.
- An unauthorised UK based alternative for joint ventures, club deals and funds that intend to predominantly invest in UK property.
- Exempt investors (such as pension funds) that want to invest in capital assets but do not want the additional complexities of the EUUT regime or want an alternative to pension fund pooling arrangements.

5. The tax treatment of a RIF

The RIF tax rules have not been finalised and are still subject to consultation. We discuss below the proposals in the Draft RIF Regs and indicate the key changes we would like to see in the Updated RIF Regs when released.

A contractual scheme has no legal personality and the default position should be that it is broadly disregarded for tax purposes. When adopted, the new regulations will alter that default position and confirm what the tax treatment of the RIF should be.

5.1. Creation of the RIF-UC Regime

The Draft RIF Regs create a more favourable tax regime for RIFs (the "**RIF-UC Regime**") that is based on the contractual scheme falling within at least one of the three following usage cases (each a "**RIF-UC**"):

(a) UK property rich (75% or more of its gross asset value is UK property).

(b) Exempt unitholders (all unitholders must be exempt from CGT).

(c) De minimis UK property (holds only a de minimis direct or indirect interest in UK property).

In addition to being within one of the RIF-UCs, a contractual scheme must meet a number of other requirements, including:

- being an Alternative Investment Fund;
- being UK-based (e.g. UK-based operator and depositary and documentation subject to UK law);
- satisfying a genuine diversity of ownership or non-close test, intended to ensure that a RIF is either widely held or owned by specified categories of "institutional investors"; and
- providing notification to HMRC.

The RIF must satisfy all of the conditions on an ongoing basis to benefit from the RIF-UC Regime tax treatment described below.

5.2. Tax treatment in the RIF-UC Regime

UK tax on chargeable gains ("CGT")

While in the RIF-UC Regime, the CGT treatment of both the RIF and its investors are altered, so as to enable the RIF to operate effectively as a collective investment vehicle:

- Effectively no CGT on disposals by the RIF (i.e. the same as a CoACS).
- Investors are no longer treated as owning the assets of the RIF but instead the units in the RIF are treated as shares in the hands of investors.

The Draft RIF Regs confirm that a contractual scheme that is not in the RIF-UC Regime is treated like a partnership for CGT purposes. For most collective investment vehicles, partnership treatment is not ideal because of the risk of "dry" tax charges when profit entitlements change (e.g. changes in the composition of investors).

A RIF that has fallen out of the RIF-UC Regime can rejoin the regime when the conditions are met again such that the adverse tax treatment is not necessarily permanent, but any period outside the RIF-UC Regime would be challenging for both the RIF and its investors.

The CGT treatment in the RIF-UC Regime reflects what industry had been expecting. However, the CGT downside risk of falling out of the regime is potentially material and the adoption of the RIF will be dependent on how confident Operators are that they can adopt procedures to reduce that downside risk to an acceptable level.

We consider below the current proposals as to how the risk of falling out of the RIF-UC Regime can be managed and the concern in industry that the risk of falling out of the regime is currently too great.

Stamp Taxes

Stamp Duty Land Tax ("SDLT")

Entering the RIF-UC Regime

On entry into the RIF-UC Regime, the RIF is subject to SDLT on the market value of all property that it owns in England and Northern Ireland at that time. This requirement reflects a concern that the RIF-UC Regime could be used to "envelope" property and avoid SDLT on a subsequent sale of RIF units. While we consider that this risk could be dealt with in other ways, given that a RIF can enter the RIF-UC Regime before it owns any property, we can see that this risk should be manageable.

Treatment within the RIF-UC Regime

SDLT treatment in the RIF-UC Regime reflects what industry had been hoping for:

- The RIF (not its investors) is subject to SDLT on acquisitions of property.
- In certain circumstances, an acquisition of property by the RIF in consideration of an issue of units is exempt from SDLT (i.e. seeding relief but risk of clawbacks).
- Dealings in RIF units are not subject to SDLT (i.e. RIF treated as a company).

Falling out of the RIF-UC Regime

A RIF that has claimed seeding relief from SDLT would potentially suffer a clawback of that relief if it were to fall out of the RIF-UC Regime.

Outside the RIF-UC Regime, SDLT treatment defaults back to being transparent such that investors are subject to SDLT on acquisitions of property by the RIF and SDLT is payable on transfers of RIF units.

Re-entering the RIF-UC Regime

A RIF that satisfies the conditions again can re-enter the RIF-UC Regime, which would switch back on this favourable tax treatment. However, re-entering the RIF-UC Regime could trigger the SDLT entry charge again unless:

- there had been no change in the composition of the RIF's investors since it left the RIF-UC Regime; and
- the RIF did not acquire any property while outside the RIF-UC Regime.

If the composition of the RIF's investors stayed the same but the RIF acquired property while outside the RIF-UC Regime, the SDLT entry charge would only apply to the market value of the newly acquired property. However, if the composition of the RIF's investors has changed, the full entry charge would be payable on all property owned by the RIF, whether the RIF had acquired new property or not.

This creates a risk of the RIF being subject to multiple charges to SDLT on the same property: when the RIF first acquires the property; on entry into the RIF-UC Regime (but possible to manage this risk); and if required to re-enter the RIF-UC Regime. Real estate funds only ever factor in one charge to SDLT; any additional SDLT would directly impact on a fund's returns.

Conclusion

The SDLT treatment within the RIF-UC Regime enables the RIF to successfully operate as a collective investment vehicle. Falling out of the regime creates a number of potential SDLT issues: (i) clawback of seeding relief; (ii) risk of additional unexpected SDLT charges (different to CGT which simply accelerates a charge); and (iii) potential for investors (not the RIF) to be required to file and pay SDLT.

The potential SDLT risks of falling out of the RIF-UC Regime are material: (i) potentially increasing the amount of SDLT payable as compared to other fund structures or direct investment; and (ii) creating additional tax and administration burdens for investors. Therefore, the risks associated with falling out of the RIF-UC Regime are actually more severe from an SDLT than from a CGT perspective.

We consider that the RIF-UC Regime should not govern the SDLT treatment of the RIF at all and that any SDLT concerns should instead be dealt with using targeted anti-avoidance provisions. We hope that this position will be reflected in the Updated RIF Regs.

Wales and Scotland

We are not aware of any current intention to adopt specific rules to deal with the RIF for the purposes of Land Transaction Tax in Wales or Land and Buildings Transaction Tax in Scotland. This would be another potential issue for strategies involving property in Wales or Scotland.

Stamp Duty and Stamp Duty Reserve Tax ("SDRT")

While within the RIF-UC Regime:

- The RIF pays stamp duty or SDRT on the acquisition of shares and securities.
- Seeding relief is available in the event that shares or securities are transferred to the RIF in consideration of an issue of units in the RIF to the transferor.
- Dealings in RIF units (e.g. subscriptions and transfers) are not subject to stamp duty or SDRT.

Under the Draft RIF Regs it would seem that any contractual scheme that is not within the RIF-UC Regime would cease to get the benefit of the stamp tax treatment above and so would potentially cause investors to be subject to stamp tax on both: (a) acquisitions of shares and securities by the RIF; and (b) acquisitions of units in the RIF by investors.

Once again, while within the RIF-UC Regime the proposals from a stamp duty and SDRT perspective reflect what industry was expecting. Any change in that treatment on leaving the RIF-UC Regime constitutes another material obstacle to the adoption of the RIF.

5.3. Taxes not impacted by the RIF-UC Regime

Taxes on income

Any contractual scheme will be and remain transparent for the purposes of tax on income, whether it is within the RIF-UC Regime or not. RIFs will also be able to adopt the same capital allowances treatment as a CoACS, such that the RIF can manage capital allowances claims directly, making it simpler and more efficient for taxable investors.

VAT

A RIF should be able to register for VAT and opt to tax UK properties, so as to be able to make VATable supplies (i.e. similar to a CoACS). However, supplies of management services to any RIF will be VATable and not exempt (i.e. different from a CoACS).

If the RIF is carrying on VATable activities, VAT should be recoverable by the RIF but there may be scenarios (such as residential property portfolios) where irrecoverable VAT would represent a real cost. The VAT treatment of funds generally remains an area of industry lobbying.

5.4. Risk of falling out of the RIF-UC Regime

In order to remain within the RIF-UC Regime, the RIF must continue to meet the entry conditions and also satisfy a number of additional administrative requirements.

Many of those conditions are within the Operator's control such that one would expect the risk of breach to be manageable. However, certain conditions could be breached without the Operator being able to prevent, or potentially even being aware of, the breach:

- Non-close test (e.g. a transfer of units between investors or a change in the composition of an investor).
- Individual RIF-UC requirements: (a) UK property rich: acquisition or disposal of an asset by a subsidiary entity; (b) exempt unitholders: an investor ceasing to be exempt; or (c) de minimis: acquisition of UK property by a subsidiary.

Grace periods in the Draft RIF Regs

The Draft RIF Regs seek to deal with the risk of breaching the conditions by providing grace periods to allow the breach to be rectified. Although this is potentially helpful, the grace periods currently proposed are too short and do not take account of the fact that the Operator may not even be aware of a breach.

The Draft RIF Regs provide a nine month grace period for breach of the UK property rich RIF-UC and, given there is a greater likelihood that the Operator would be aware of the breach, should at least give the Operator a fighting chance of rectifying the breach within the grace period.

However, other grace periods are only 30 days from the date of the breach, even though there is no guarantee that the Operator would be aware of that breach. Even if the Operator were aware, the chances of rectifying a breach (e.g. changing the investor base to satisfy the non-close condition) within 30 days are remote at best.

Effect of falling out of the RIF-UC Regime

There is therefore a definite risk of an accidental or innocent breach of the RIF-UC Regime conditions and no guarantee that an innocent breach will even be capable of being rectified within any grace period. That would result in the RIF leaving the RIF-UC Regime, causing:

- Investors to make a market value deemed disposal and reacquisition of their RIF units, with the timing of the charge to CGT on any associated gain depending on the reason for exiting the RIF-UC Regime.
- The RIF to revert to partnership treatment for CGT purposes and transparent treatment for stamp tax purposes.

- A potential clawback of any SDLT seeding relief claimed.

Being outside the RIF-UC Regime creates a risk of dry tax charges for investors which would be extremely challenging for the RIF and, to an even greater extent, its investors. For example, any acquisition or disposal of property by a RIF that has fallen out of the RIF-UC Regime would potentially expose its investors to SDLT or CGT, which the investors would themselves have to report and pay to HMRC. This position would not be acceptable to investors and could threaten the ongoing existence of the RIF.

This is exacerbated when one considers that the grace periods are not triggered by awareness, meaning that the RIF could have innocently been operating on the basis that it was within the RIF-UC Regime (e.g. acquiring or disposing of assets) when it was not, and investors could have unwittingly failed to report and pay material amounts of tax. Even a small risk of what could be material tax liabilities and compliance failures by investors would constitute a serious barrier to the adoption of the RIF.

6. Potential to improve the RIF-UC Regime

The RIF-UC Regime is intended to deal with a valid concern that non-UK investors might otherwise be able to dispose of UK property without being subject to CGT.

However, as currently drafted, the RIF-UC Regime goes beyond what is required to resolve that concern in two key ways: (1) it extends beyond CGT to adversely impact the RIF's treatment for other tax purposes; and (2) it puts the tax treatment of the RIF at a fundamental disadvantage when compared with other structures, both UK (e.g. the EUUT) and non-UK (e.g. Luxemborg, the Channel Islands and Ireland).

While the RIF-UC Regime provides a tax treatment that would enable a RIF to compete with these established fund structures, the risk of falling out of the regime would make it hard for fund managers to choose the RIF over more tried and tested options except in certain niche usage cases (e.g. existing CoACS wanting to reduce regulatory burden).

We consider that the following changes would help to improve that risk ratio significantly and encourage the adoption of the RIF:

- Grace periods in respect of breaches need to be more realistic and targeted at preventing abuse:
  - Move away from prescriptive "one size fits all" time periods to rectify breaches, for example requiring breaches to be rectified as soon as practicable.
  - If time periods are considered necessary, they should better reflect the relevant test (e.g. the non-close test may take longer to rectify than the UK property rich test) and have the ability to be extended by agreement with HMRC.
  - Grace periods should run from the date on which the Operator becomes aware, or potentially from the date on which the Operator ought reasonably to have become aware, of a breach.
- The RIF-UC Regime was designed to deal with a potential CGT issue and compliance with the RIF-UC Regime should only affect CGT. For example, the stamp tax treatment of the RIF should remain constant even after leaving the RIF-UC Regime. Other concerns (e.g. enveloping property) should be dealt with using targeted anti-avoidance rules.

7. Conclusion

While we accept the need for the RIF-UC Regime from a CGT perspective, the version provided for in the Draft RIF Regs is too restrictive and the risk of innocently falling out of the RIF-UC Regime is so great that it risks severely limiting the adoption of the RIF. We look forward to seeing the Updated RIF Regs and hopefully a more balanced RIF-UC Regime in the near future.

To discuss the Draft RIF Regs or the expected Updated RIF Regs, contact Paul Shaw and Matthew Poole