

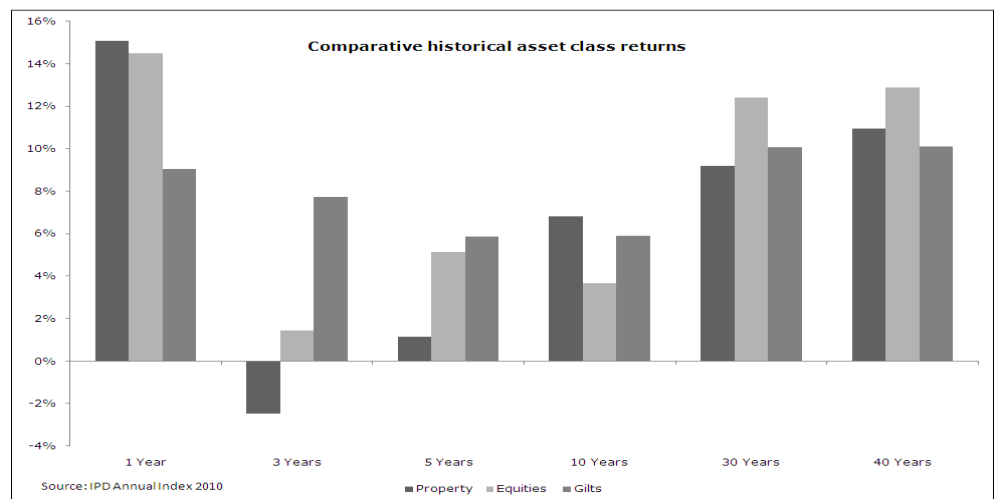


PAIFs: evolution and outlook

Stephen Elliott, Property Fund Manager

With Property Authorised Investment Funds (PAIFs) receiving increasingly wider coverage of late, and given their status as relative newcomers to the investment landscape, it may be helpful to start out by explaining how they came into being. In March 2008, following a period of consultation between the investment management industry, the Financial Services Authority (FSA) and HM Revenue & Customs (HMRC), the UK government introduced the Authorised Investment Funds (Tax) (Amendment) Regulations 2008. These regulations enabled authorised investment funds investing mainly in property or certain property-related assets to benefit from exemption from corporation tax on returns from property investment.

Along with regulations relating to Stamp Duty Land Tax exemptions for open-ended investment companies, also introduced in 2008, this paved the way for the introduction of PAIFs at the start of the 2008/09 tax year. Underlying the superficially complex legal wording and taxation arrangements was a straightforward aim: to make investment in property funds more attractive to a wider range of investors. However, unfortunately for the regulators their good intentions came to fruition at the same time as a significant downturn in the property market. Therefore the desire of investment managers to launch or convert funds looking to take advantage of the newly-available structure, together with the appetite of investors for them was severely limited. By way of illustration, the chart shows the significant impact of market weakness in 2008 and 2009 on the three year performance of the asset class, given the extent of the recovery in 2010.



It was therefore another two years until such funds started to appear, as property prices started to recover, along with investor interest. More recently interest has continued to grow, culminating in some recent high profile launches as fund providers seek to exploit the beneficial tax status that PAIFs offer investors. At Royal London Asset Management (RLAM) we are strong proponents of these benefits. As the first company to convert an existing property investment vehicle to a PAIF, we believe that we are very well placed to comment on developments within this area of the market. We have been actively involved in consulting with regulators and industry bodies, and sharing our experiences with other asset

managers. For example the Association of Real Estate Funds (AREF), which has almost 70 member funds with a combined value of about £30 billion, has established a working group on PAIFs to assist with the conversion of existing portfolios. We are pleased to see that other fund providers are starting to recognise the opportunities and advantages that such funds offer and are following our lead in bringing new offerings to the market. This is a trend that we expect to continue, and with it we look forward to increased market awareness of PAIFs as their advantages become increasingly widely acknowledged.

So how do PAIFs differ from other property vehicles and what are these advantages that they offer? In comparative terms, PAIFs are to OEICs as REITs are to investment trusts. In other words they are open ended investment vehicle, structured as corporate entities, which can invest in a wide range of property assets. Such assets include physical property (both commercial and residential), shares in UK real estate investment trusts (UK REITs), exchange traded funds and other collective investment vehicles. The flexibility of the PAIF structure enables better management of short term liquidity and offers the potential for greater diversity through access to specialist assets, such as shopping centres, indirectly via collective investments.

Their attractiveness lies largely in the benefits offered by their tax treatment, as they allow both taxable and tax exempt investors to participate in the same fund on a tax efficient basis. They are designed to be tax transparent vehicles, thereby creating no tax liability in respect of investment income. Income from direct property and from shares held within a PAIF is taxed as though the investment was held in the underlying assets directly. PAIFs are not liable to a withholding tax on investment income. In other words whereas authorised investment funds investing in real estate previously suffer a 20% charge on their taxable income that could not be recovered, PAIFs can pay gross dividends from property rental income without the deduction of corporation tax.

Prior to the introduction of the PAIF structure, tax exempt investors such as pension schemes, charities and ISA investors investing in property via such traditional authorised funds faced a number of taxation issues. Although these investors were exempt from tax on rental income received directly, they were not exempt from tax on income received from authorised funds. In contrast, the advantage of the PAIF structure is that the point of taxation is moved from the fund to the investor, meaning that the investor is taxed on the property income as if the property was held directly. This opens up opportunities to a much wider range of investors, while posing no tax disadvantage to existing investors.

The PAIF structure allows for the delivery of three streams of income: first, property income, i.e. that derived from the rental income paid on properties held directly in the fund; second, interest income, i.e. that paid out from any bank interest or income into the fund; and third, dividend income, i.e. that arising from dividends paid by shares held in the fund. Investors are liable for tax at their own marginal rate on each of these three types of income and at each distribution they receive a tax voucher describing the types of income received. The required 20% tax on the property and interest streams is then deducted automatically on behalf of taxpaying investors and is submitted to HMRC on their behalf. Meanwhile for tax-exempt investors, the income is paid out (or re-invested into the PAIF) gross of taxes.

As a result of these changes the universe of potential property investors is greatly expanded. While thus far PAIFs have been primarily aimed at institutional investors, they also provide specific benefits to retail tax-exempt investors such as ISA holders. For example, the Investment Management Association (IMA) calculates that investors using their full ISA allowance to invest in a traditional property fund pay £80 a year in irrecoverable tax (assuming a net yield of 3.2%), which they would avoid in a PAIF. With more than £200 million invested in direct property fund ISAs, this equates to over £1.5 million being paid in tax rather than

being retained by investors. Furthermore, other tax exempt investors such as SIPP holders, pension funds and charities will enjoy similar benefits. Along with a range of market participants and other trade bodies, the IMA has also recognised the need for PAIFs to be available through a wider range of retail platforms, and wrap and platform providers are working towards a fully automated solution that would allow PAIFs to meet the requirement to stream distributions.

In conclusion, launches of new funds and conversions of existing ones should be viewed as positive developments within the market. Property is a long term, diversifying asset and as the chart shows, notwithstanding the volatility at the end of the last decade, the longer term returns - and investment case - remain very much intact. Clearly the property sector was not immune from the market turmoil which hit most asset classes in 2008, causing many investors to re-assess their exposure, although recent evidence points to investors returning in good numbers, hopefully suggesting that 'normal service has been resumed'. In recognition of the important role of the asset class within the context of a broader, diversified portfolio, it is clearly beneficial to the market for PAIFs to become the primary property investment vehicle and all steps in this direction are to be welcomed. PAIFs facilitate investment from a broader range of investors, which is in turn expected to strengthen the sector as a whole. The number of PAIFs currently available is relatively restricted, although we look forward them becoming more widespread over the next few of years as the property sector continues to improve and a growing number of fund providers look to take advantage of their more beneficial tax structure.

Source: rlam as at 1st July 2011 unless otherwise stated.

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