Review of the UK Funds Regime

20 April 2021
To: UKfundsreview@HMTreasury.gov.uk

Introduction and background

The British Property Federation (BPF) represents the real estate sector – an industry which contributed more than £100bn to the economy in 2019 and directly employed more than 1 million people[1]. We promote the interests of those with a stake in the UK built environment, and our membership comprises a broad range of owners, managers and developers of real estate as well as those who support them. Their investments help drive the UK's economic success; provide essential infrastructure and create great places where people can live, work and relax.

We are supportive of the government's bold ambitions to bolster the UK's position as a centre for asset management services and create jobs across the UK. Due to the bulky and illiquid nature of real estate investment, it naturally lends itself to collective investment – to allow investors to share risks and pool resources. Removing barriers to channelling collective investment into real estate will not only be helpful in bolstering the funds industry in the UK – it will be crucial to addressing some of the biggest challenges of our time – including our net zero carbon targets, the regeneration of our high streets, and the development of more high quality homes.

Our response to the consultation questions can be found in the appendix - please do not hesitate to get in touch if you require further information. We look forward to engaging further on the wider funds review and associated workstreams in due course.

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[1] https://bpf.org.uk/about-real-estate/

Review of the UK Funds Regime

Appendix 1: Response to consultation questions

Chapter 1: Introduction

Question 1: This call for input on the UK funds regime is necessarily wide-ranging. As the government would not be able to take forward all proposals immediately, what do you think the top 3 priority proposals should be for government implementation and why?

1) Our top three priorities for the review of the UK funds regime are set out below:

   a) **Dedicated Government task force:** The asset management sector will continue to evolve, as will the approaches adopted in competitor jurisdictions. To that end, the UK government's approach must be responsive, long term and truly holistic. In order to ensure that the government is well placed to support and respond to the sector's needs, a new dedicated Government task force should be set up – which brings together expertise from a broad range of relevant areas, including tax, regulation and corporate law – with a mandate to be responsive and agile in making recommendations to government to support the sector. The remit of the group should include a wider review of the UK tax landscape, to ensure that relevant areas of the tax rules remain appropriate and supportive of the asset management sector.

   b) **Broadening of the REIT regime to support net zero and communication and digital infrastructure assets:** There is a huge opportunity for the Government to utilise the REIT regime to help it achieve its objective of net zero emissions by 2050 and to support its communication and digital strategies (e.g. Building Digital UK and Project Gigabit broadband programmes). In particular, by broadening the asset classes that a REIT can invest in, it could provide a route for capital to be channelled into, for example, renewable energy generation and other technology and infrastructure to enable that transition.

   c) **Unauthorised funds to suit professional investors and join venture arrangements:** There is currently a lack of suitable unauthorised UK fund vehicles which are appropriate for professional and institutional investors – and of particular relevance for real estate, are fund vehicles that are suitable for joint venture arrangements. Not all funds will be suitable for all investors and all investments – and therefore, it is appropriate to have a range of flexible options. To that end, we support the development of a range of Onshore Professional Funds, including the 'Professional Investor Fund' unauthorised contractual scheme ("PIF"), as outlined in Chapter 4 of the consultation.

2) We would also take the opportunity to reiterate the importance the Asset Holding Company (AHC) regime consultation – which will be fundamental to the government's ambitions to bolster the UK asset management sector in the UK. As well as ensuring that investor returns can be repatriated through UK fund structures without suffering double tax, the new AHC regime must be simple to understand and administer. Furthermore, given the new AHC regime is proposed to include stringent eligibility criteria, it will be important for the government to carry out a wider review of the UK tax landscape – to ensure that the AHC regime does not create a huge cliff edge for different commercial structures which fall short of any eligibility criteria.

Chapter 2: The UK's approach to fund taxation

Question 2: How effective were recent reforms to UK funds taxation in achieving their aims? Please explain your answer. Could anything have made these reforms more effective, particularly in terms of increasing the attractiveness of the UK as a location to set up funds?

3) **SSE**: While the recent changes to the SSE rules in 2016/2017 were helpful, the UK's regime is still far less ambitious than equivalent regimes in other jurisdictions. In particular, many other countries do not make the same distinction between trading companies and real estate investment companies – but rather, the exemption from gains on share sales applies equally to both types of businesses. In order for the tax environment in the UK to work equally for all investment asset classes, the benefits of the SSE regime should be extended to real estate investment companies, as well as trading companies.

4) **ACS (Authorised Contractual Scheme) SDLT change**: While a transparent fund structure is very helpful for many collective investment structures, SDLT can pose a challenge where transfers of units in the fund are deemed to be sales of the underlying property. To that end, the recent changes to the ACS rules to ensure that a transfers in a unit of the fund would not constitute an SDLT event were very helpful.

5) **REIT changes in 2012:** A number of significant changes were made to the REIT regime in 2012, such as the relaxation of the close company condition for institutional investors, and the removal of the entry charge, which had a major positive effect. Until 2012, the REIT population remained around 20. However, since the 2012 changes, the number of REITs has more than quadrupled, with a large proportion of the REITs being owned and funded by institutional investors.

Tax elected funds

Question 3: Why has uptake of TEFs been limited? Please explain any operational or commercial factors that have influenced their uptake. How could these be addressed?

Question 4: How would the proposals in paragraph 2.9 improve tax efficiency of multi-asset authorised funds? Please explain how the proposals would work in practice and how a proportionate impact on HMRC could be ensured.

Question 5: Are there are any additional changes the government could consider to reduce tax leakage in multi-asset/balanced authorised funds?

6) Our members have not made use of tax elected funds so we have not commented in detail. We would note that the logic behind them seems sensible – however, the perception is that they are over complicated in practice, which may have put off investors.

Tax exempt funds

Question 6: Where funds are already tax neutral, how would a tax-exempt status for funds influence decisions about how and where to set up funds?

Question 7: How would tax-exempt funds affect the competitiveness and attractiveness of the UK funds regime? Please explain your answer providing evidence and international comparisons where possible.

7) Tax exempt funds are helpful – in particular when they are straightforward and easy to understand. We already have two forms of tax-exempt vehicle for real estate in the UK – the PAIF (Property Authorised investment Fund) and the REIT (Real Estate Investment Trust).

8) However, these funds will not be appropriate for all investment structures and will not suit all investors – typically they will be less appropriate for smaller investors or investments – or where fund authorisation is not necessary (such as for professional investors). In these cases, a number of other structures may be used, which seek to obtain a tax transparent outcome at the fund level.

9) We consider that there is a gap for an unauthorised fund for professional investors in the UK. We would support some reforms to English Limited Partnerships to help fill this role in the UK (see response to question 12) – and we would also support the introduction of a PIF (as touched on in greater detail in questions 30-37).

Real Estate Investment Trusts ("REITs")

Question 8: What would be the likely impact if changes were made to the REIT regime in the areas discussed in paragraph 2.16? To what extent could investment in the UK be expected to increase, and what would be the drivers for this? Could such changes be expected to impact the extent to which funds with UK and foreign property assets are managed in the UK?

Background

10) There are currently around 100 UK REITs that own approximately £100bn of property investments. REITs are seen by both Government and the property industry as a key means of attracting UK and overseas capital into the UK built environment. We commend the Government's desire to remove "unnecessary barriers and complexity" such as those set out in paragraph 2.16, in order improve its attractiveness.

11) There is empirical evidence that taking such actions can materially increase the use of REITs. For example, a number of significant changes were made in 2012, such as the relaxation of the close company condition for institutional investors, and the removal of the entry charge, which had a major positive effect. Until 2012, the REIT population remained around 20. However, since the 2012 changes, the number of REITs has more than quadrupled, with a large proportion of the REITs being owned and funded by institutional investors.

12) However, we believe that there is a huge opportunity for the Government to utilise the 'tried and tested' REIT regime to help it achieve its objective of net zero emissions by 2050. In particular, by broadening the asset classes that a REIT can invest in, it could provide a route for capital to be channelled into, for example, technology and infrastructure to enable that transition. We set out our recommendations in this respect, in our response to Question 9 below.

13) First, we comment on the specific measures set out in 2.6.

The interest cover test

14) As stated under 2.6, larger REITs are now also subject to the Corporate Interest Restriction and it is burdensome having both tests. Furthermore, REITs tend to have very modest gearing and the REIT interest cover test is rarely, if ever, failed.

15) To that end, we agree that the interest cover test is no longer necessary.

The 3-year development rule

16) The 3-year development rule turns what are, under general tax principles, gains on disposals of investments which should be exempt for REITs, into taxable gains.

17) The 3-year development is an anomaly and is not found in any other part of the tax legislation – nor is it a feature of other regimes hat we are aware of. Indeed, the 3-year development rule puts REITs at a disadvantage when compared with the capital gains exemption afforded to companies that have made an exemption election under NRCGT (Paragraph 12 Schedule 5AAA TCGA 1992). There is no equivalent to the 3-year development rule, disallowing the exemption in the NRCGT rules.

18) Furthermore, the 3-year development rule does not operate in an equitable way. For example, the cost of development is compared with fair value, measured at the date the company entered the REIT regime or acquired the asset (whichever is the later), which might be over 14 years ago. At the very least, the legislation should be amended so that the cost of development is compared with, for example, an updated value of the property at the time that development is commenced.

19) The interaction of the 'blunt' 3-year development rule with the REIT share sale exemption (s556(3A-3C) CTA 2010) can also create arbitrary and inequitable results in the context of a share sale of a portfolio of properties. For example, where on a portfolio sale only one of the properties has been recently developed within the scope of the 3-year development rule, and that development was part of the ordinary course of managing the property portfolio (i.e. without any 'offending' intention to profit from the sale of that particular property post-development, and without that one property having any particular significance in the context of the portfolio as a whole or on any future share sale of the portfolio as investment properties generating long-term rental income and capital growth), the application of s556(3A-3C) to restrict the REIT share sale exemption can actually act as a deterrent to investment and deployment of capital by REITs into individual properties within a portfolio of assets.

20) We would suggest that the REIT legislation is simplified by repealing the 3-year development rule. Instead, well-established case law on the distinction between trading and investment, together with Transactions in UK Land provisions, should be used to determine whether a REIT has made an exempt gain on the disposal of an investment, or a taxable profit.

The 3 properties rule

21) The 3 properties rule is currently acting as an impediment in relation to the formation of REITs to hold a single property such as a major logistics warehouse that may be configured for sole occupation by a single tenant, the value of which could run into the hundreds of millions.

22) Repeal of this rule could help attract more capital into this, and other, important areas of the economy.

23) In addition, as a consequence we would suggest that the 40% value condition in s529(2) should also be repealed.

REITs holding overseas properties in a UK company

24) The current treatment under the REIT regime of overseas property rental profits and gains arising to a UK company creates a double layer of tax - once in the overseas jurisdiction and then again when distributed to shareholders, without full relief being given for overseas tax suffered.

25) We would suggest overseas property rental profits and gains made by a UK company in relation to its UK property rental business remain exempt, but can be distributed to shareholders as ordinary dividends, rather than being subject to tax in shareholders hands as 'PIDs'.

26) Furthermore, where the shares in such a UK company holding overseas property (or in fact, any non-UK company holding overseas property) were to be sold, any gain on such a share sale should similarly be exempt from UK tax and should be distributed by the REIT to its shareholders as ordinary dividends rather than as PIDs.

27) We anticipate that such changes would encourage REITs to hold their overseas investment properties in UK companies, rather than in e.g. Luxembourg, Dutch or Jersey companies.

Further comments

28) For the reasons set out above, we would support repeal of the interest cover test; 3-year development rule; and the 3 properties rule. We would also support reform of the way in which overseas properties held by UK companies that are members of a REIT group are taxed.

29) As stated under 'Background' above, there is empirical evidence from the REIT changes made in 2012 that improvements in the REIT regime could have a positive effect on their use. In aggregate the potential changes outlined above are likely to have positive effect on the level of investment channelled through UK REITs.

Question 9: Are there any other reforms to the REIT regime that the government ought to consider, and why?

30) We would reiterate the suggested REIT changes we proposed in our response[2] to the Asset Holding Company consultation earlier this year. In particular, the importance of relaxing the listing requirement where a REIT is owned by institutional investors, improving the operation of the institutional investor relaxation in the close condition, simplifying the holder of excessive rights rules in certain cases, and simplifying the balance of business test.

31) We set out further reforms that the government should consider below - both to support the government's ambitions to bolster the asset management sector in the UK; but also to enable

[2] https://bpf.org.uk/media/3760/ahc-bpf-response-23-feb-2021.pdf

the REIT regime to channel investment to address some of the biggest challenges of our time – namely the net zero carbon agenda.

Broadening the asset classes that a REIT can invest in – e.g. to support net zero and communication and digital infrastructure assets

32) As stated under 'Background' above, we believe that there is a huge opportunity for the Government to utilise the REIT regime to help it achieve its objective of net zero emissions by 2050 - and also to support its communication and digital strategies (e.g. Building Digital UK and Project Gigabit broadband programmes). In particular, by broadening the asset classes that a REIT can invest in, it could provide a route for capital to be channelled into, for example, renewable energy generation, and other technology and infrastructure to enable that transition.

33) The REIT regime is currently too restrictive in terms of the types of assets it can hold and the types of activities it can carry on and these restrictions inhibit REITs from being able to raise capital in the UK and overseas for desirable objectives, such as net zero emissions by 2050. For example, rents in respect of the siting of wind turbines and masts or similar structures for mobile telephone networks or other systems of electronic communications are excluded from tax exempt property rental business (Section 604 CTA 2010).

34) In addition, many infrastructure businesses involve activities which could be viewed for UK tax purposes as either investment businesses (earning rental income) or trading businesses (earning service revenues) depending on how they are organised and the contractual relationships with their customers. For example, many involve customers essentially paying charges to access or utilise the capacity or transmission capabilities of substantial structures such as pipelines, data cables, cloud based data storage systems etc., but generally are structured as service businesses that would not be regarded as generating rental or similar income from the exploitation of land.

35) REITs should be allowed/encouraged to undertake investment activities to help the Government to, inter alia, achieve its net zero emissions targets, such as investing in, renting out and enjoying income from wind turbines, solar farms and other desirable asset classes and infrastructure, and its communication and digital strategies.

36) We believe the ability to hold renewable energy and infrastructure assets in a REIT would lead to increased demand for these investment opportunities and increased investment into the UK, matching the increase in funding needs driven by the Government's Plan for Growth.

37) The US provides an existing example of a REIT regime that has already evolved to permit a broader range of asset classes, including digital and communication infrastructure, data centres, mortgage REITs etc. Examples of US REITs operating within digital and communications infrastructure and renewable energy assets include:

US REIT	**Operating area**
American Tower Corporation	A global provider of wireless communications infrastructure and next generation wireless technologies to enable 5G
Crown Castle International Corp	Provider of communications infrastructure such as cell towers, small cells, fibre cables
Weyerhaeuser Company	Owner and manager of timberlands across the US and Canada, with a focus on renewable energies (e.g. by granting easements over land to renewable

	energy providers who build wind turbines and solar farms)
Equinix Inc.	Global owner and operator of interconnected, colocation data centres rented to retail customers
Digital Realty Trust, Inc.	Investor in carrier-neutral data centres and provider of colocation and peering services

38) Together, the above 5 US REITs have a market capitalisation of USD 315.5 billion as at 6 April 2021.

39) In order to accommodate these businesses, the US REIT regime effectively treats relevant assets and businesses as akin to real estate assets and generating qualifying real estate income where required, through permissive legislation and rulings. In many cases, there is still an associated 'trade' element such as the provision of ancillary services which remains taxable, but the core infrastructure business largely benefits from the US REIT regime's exemptions.

40) This US approach is in contrast to that taken in the UK in 2006/2007 in relation to self-storage businesses, where the businesses themselves had to commercially restructure their dealings with customers (and change their terms and conditions) in order to re-position themselves with HMT agreement as property rental businesses (with an ancillary trading activity relating to sales of insurance, storage boxes etc. falling within the REIT residual business). We do not believe that an approach that is reliant on businesses themselves changing their activities or relationships with customers would be commercially realistic or possible in the context of infrastructure businesses, i.e. we would consider that it is the UK REIT regime that needs to change rather than the businesses themselves.

41) We would therefore recommend HMT consults on the addition of a 'permissive list' within the UK REIT regime (in contrast to the existing 'negative' lists in ss604/605) that could be amended and updated as required by HMT through regulations. Such a permissive list could specify assets and activities / businesses that would be treated as qualifying property rental business assets and generating qualifying property rental business profits for the purposes of the UK REIT balance of business tests and / or REIT tax exemptions, as is considered appropriate in each case. The initial population of such a permissive list could be focussed on infrastructure businesses and renewable energy assets that support the Government's Plan for Growth – but further asset classes can be considered periodically to support other government initiatives.

42) In addition to the net zero carbon agenda, the REIT rules must adapt to reflect common practices in real estate investment as it evolves. A permissive list, as suggested above, could also allow the REIT regime to be more agile in responding to changes in business activities, models and asset-classes over time. For example, as a response to the Covid-19 situation many commercial office landlords are increasingly looking to modernise their offerings to tenants to become more flexible and with more bundled services (in some cases moving towards a 'co-working' flexible space and 'service-led' model rather than a traditional 'leasing' model). Such businesses are often hard to analyse from a 'trading or property rental business' perspective and can cause tension with the REIT 'owner-occupied' exclusion in s604(2) CTA 2010. A permissive approach that could give clarity as needed over time as to whether such businesses can elect into and/or be eligible for REIT exemptions (either as stand-alone businesses, or perhaps alternatively only where they are ancillary activities sitting alongside a larger, more traditional REIT leasing businesses) would be welcomed.

Encouraging commercial and residential property-owning REITs to invest in renewable energy assets

43) Currently, where a UK REIT invests in renewable energy assets (e.g. by installing solar panels on their buildings and supplying the 'green energy' produced to its tenants or the national grid) these assets and associated income are likely treated as non-qualifying 'bad' assets from a REIT balance of business perspective and not eligible for REIT exemptions.

44) In recent years, there has been a significant increase in the number of REITs that are actively seeking to increase their green energy contribution, and this current treatment is a real commercial disadvantage to them. Green/eco funds are also becoming increasingly important among investor bases and as such are expected to be particularly relevant as a potential source of capital for the listed market in future.

45) We believe that the REIT regime should encourage (rather than discourage) commercial and residential property-owning REITs to invest in renewable energy assets in order to support moving their own property portfolios and tenants' businesses towards net zero emissions.

46) We would therefore suggest that such investment should be treated as 'good' for the REIT balance of business tests and qualifying for REIT exemptions where it is otherwise ancillary to a predominant property rental business. This could also be achieved through the permissive list approach referred to above.

Seeding relief for REITs

47) There is currently a Stamp Duty Land Tax seeding relief available for seeding PAIFs and COACS with properties. This relief is particularly important for institutional investors seeking liquidity for, or co-investment in, portfolios of assets held by them.

48) It is anomalous that there is no such seeding relief available for seeding a REIT with properties. This would not only be useful for institutions seeking to use a REIT rather than a PAIF or a COACS to suit their commercial objectives but could also be useful for occupiers of property seeking to raise capital by placing their assets in a REIT. Institutions and other property owners, and indeed retail investors, may well prefer to invest in property via a REIT rather than an opened-ended vehicle such as a PAIF.

49) We would further note that a roll-over of capital gains would also be needed to help facilitate the creation of REITs from these existing portfolios – where a portfolio is transitioned to a REIT without a change in ownership, it should be tax neutral.

Levelling the playing-field with the NRCGT exemption regime

a) *Wind-up of REIT structures*

50) The REIT regime as introduced in 2007 was essentially focussed on the listed property sector, which largely consisted of vehicles that could be regarded as almost 'perpetual'. As a result, the REIT regime does not include any clear provisions for how the rules and tax exemptions work on the orderly wind-up of a REIT (i.e. where the REIT is taking steps to dispose of all of its assets).

51) Complexities arise where the number of properties held by the REIT falls below the current minimum requirement of three. In such situations, REIT status could potentially be lost from the

end of the previous accounting period so that the final property disposals may not be REIT exempt. This position is further exacerbated if the REIT holds a single building consisting of multiple properties (e.g. an office building with ten separately lettable floors), where a sale of all of those properties together could again cause a breach of the REIT conditions and that sale may fall outside of the REIT exemptions (because REIT status could potentially be lost from the end of the previous accounting period).

52) Given the expansion of the REIT regime to include REITs owned by institutional investors, either individually or as joint ventures, there is an increased likelihood that the orderly wind-up of REIT structures may become more common place. Whilst in many situations a preferred exit route may be the disposal of such an institutionally owned REIT in its entirety, or an IPO of such a vehicle, that may not be possible, and it may be necessary to explore the sale of underlying assets and shares.

53) We note that the NRCGT exemption regime contains 'orderly wind up' provisions (in Para 30 Sch 5AAA TCGA 1992) where the exemption regime benefits continue until the relevant fund is wound up (notwithstanding the some of the applicable exemption conditions may have ceased to be met).

54) We would suggest that similar 'orderly wind up' provisions should also be introduced into the REIT regime.

b. Position of vacant or under development properties in relation to REIT entry/exit rebasings and REIT capital gains exemptions

55) The applicability of REIT entry/exit rebasings (s536 / s579 CTA 2010), the conditions as to property rental business (s529 CTA 2010) and REIT capital gains exemptions (s535 CTA 2010) are reliant upon the relevant properties being either 'involved' or 'used' in property rental business. This can give rise to complexities and anomalies where properties are vacant or under development, including in a group context where the group as a whole may be carrying on an active property rental business but a particular subsidiary has yet to commence a property rental business (but intends to do so, and may even have an agreement for lease / pre-let in place).

56) We note that there is a much simpler approach under the NRCGT exemption regime, where disposals of UK property or UK property-rich companies are simply exempt, irrespective of whether a property may be vacant or under development (subject to any applicability of e.g. the Transactions in UK Land rules to particular fact-patterns).

57) We would suggest the REIT rebasing, conditions as to property rental business and capital gains exemption provisions are reviewed and simplified, to remove uncertainty and anomalous results and to bring consistency with the approach under the NRCGT exemption regime.

c. Early exits and disposals within 2-years

58) In certain cases REIT entry/exit rebasings can be ignored (s581 CTA 2010) where a company or group ceases to be a REIT within 10 years of entering the regime, or a company ceases to be a member of a REIT group having been a member of the group for less than 10 years, and during the following 2-year period there is a disposal of a property rental business asset.

59) We would expect that a key policy rationale for the 2-year rule no longer exists, now that the UK non-resident capital gains tax regime has been introduced. We also note that there is no equivalent to this rule within the NRCGT exemption regime.

60) We would suggest these provisions are repealed.

61) To the extent the provisions remain, there is currently a lack of clarity as to whether this rule applies where there as an intra-group disposal either under s171 TCGA 1992 or a disposal where the property remains within the UK tax net under the same ultimate ownership (e.g. to a parent UK life assurance company). We would suggest the position of such intra-group transfers is clarified.

d. REIT entry and exit rebasings – Shareholdings

62) Currently, it is only underlying properties (i.e. land and buildings) that benefit from REIT entry and exit rebasings (s536 / s579 CTA 2010), notwithstanding that since April 2019 the REIT capital gains exemptions have been extended to disposals of shares.

63) We note that under the NRCGT exemption regime such interests would generally benefit from rebasing on exit from that regime, and so it is currently an anomaly that such rebasing does not also exist within the REIT regime.

64) We would suggest that REIT entry and exit rebasings should also be extended to rights or interest in UK property rich companies (i.e. those interests that would fall within the REIT capital gains exemption in s535A).

e. REIT capital gains 'share sale' exemptions - proportionate basis and UK property richness

65) Currently the REIT capital gains exemption for disposals of rights or interests in UK property rich companies (s535A CTA 2010) operates on a proportional basis, based on the proportion the relevant company's property rental business assets bears to the total value of its assets.

66) This proportionate rule can be difficult for REITs to apply in practice, and may lead to very small elements of gains being taxable (due to small sundry balances on a company's balance sheet that are not strictly property rental business related), notwithstanding the company's only activities are essentially property rental business related.

67) We would suggest that there should be a threshold above which full exemption is available, which would reduce the need to adjust for small, ancillary balances. We would suggest a 90% threshold.

68) We note that under the NRCGT exemption regime there is no such proportional approach, and gains on disposals of UK property-rich shares would be fully exempt.

69) In addition, anomalies can arise where a UK REIT disposes of UK property-rich shares alongside non-UK property-rich shares, due to the operation of the 'linked disposals' rule in Para 6 Sch 1A TCGA 1992. This rule was introduced as part of the UK non-resident capital gains tax regime but also applies to the REIT share sale exemption definition of a UK property-rich company (per s535A(5)(a)).

70) We would suggest that a UK REIT should have the option to disapply the effect of Para 6 Sch 1A so that the UK REIT exemption can apply to the disposal of UK property-rich shares, if it chooses, notwithstanding that the sale may be part of a larger sale transaction that is not UK property-rich overall.

71) Further, as noted under our response to Question 8 in respect of REITs holding overseas property in a UK company, we would suggest that any gain on the sale of shares in a company holding overseas property should be exempt from UK tax and should be distributed by the REIT to its shareholders as ordinary dividends rather than as PIDs.

f. 3-year development rule

72) As noted above, the 3-year development (s556 CTA 2010) is an anomaly and is not found in any other part of the tax legislation. Indeed, the 3-year development rule puts REITs at a disadvantage when compared with the capital gains exemption afforded to companies that have made an exemption election under NRCGT (Paragraph 12 Schedule 5AAA TCGA 1992). There is no equivalent to the 3-year development rule, disallowing the exemption, in the NRCGT rules.

73) We would suggest that the 3-year development rule is repealed.

VAT

74) At present, REITs listed on the main London Stock exchange are treated as special investment funds (SIFs) for VAT purposes, meaning that management services provided to those REITs are exempt from VAT. Otherwise management services provided to REITs are subject to VAT. This creates distortion and seems arbitrary – and can result in significant VAT leakage for some managers.

75) Our preference would be for the introduction of a zero-rate for fund management services. Alternatively, the introduction of an option to tax for services provided to REITs would make the regime more attractive. Further detail on VAT is included in response to Question 38.

Other areas for simplification or modernisation of the REIT regime

76) There are a number of detailed legislative improvements that could be made to the REIT regime which would help it serve its purpose better, allowing it to function in a clearer, fairer and more modern way. The last time such improvements were made was in 2012 and we suggest that these other detailed legislative improvements are made in the course of any changes made as part of this wider funds review. We propose to follow up separately with a list of other detailed technical issues that should be considered.

Question 10: Regarding the proposals covered in this call for input, are there any specific considerations that the government ought to take account of in the context of the UK's double taxation treaty network? Please provide as much detail as possible.

77) Access to an extensive double tax treaty network is a significant selling point for the investment management industry in the UK. Unfortunately, as the UK exits from the EU, we will lose the benefit of the Parent Subsidiary Directive and the Interest and Royalties Directive, which

provides beneficial WHT rates on dividend and interest payments between EU member states. We appreciate that it will be time consuming to renegotiate bilateral double tax treaties with each country – in the interest of time, we would suggest that the most popular investment locations which should be prioritised for treaty renegotiation should be Germany, Italy, Poland.

Question 11: What are the barriers to the use of UK-domiciled LP Funds and PFLPs, and how might tax changes help to address them? Please provide detailed proposals and explain your answers.

78) A partnership structure lends itself to real estate investment in many cases – especially joint venture arrangements. The transparent nature of the structure is desirable – as each investor is deemed to own the underlying real estate, and deemed to receive their returns directly, with no additional tax suffered at the fund level.

79) However, it is noticeable that the UK LP structures have reduced in popularity in recent years – while equivalent entities in other jurisdictions have been used increasingly. Some of the challenges are particularly problematic for a widely held structure. We have summarised a few of the main challenges with UK LPs, and some proposals to help address them.

80) **Statement of Practice (SPD 12)** - one significant complexity in the use of partnerships (or entities treated as partnerships) as fund vehicles – particularly in the real estate fund context – is the impact of Statement of Practice D12 (SP D12). This impacts real estate funds in particular, as post-April 2019 investors in property funds may well be within the scope of UK tax on gains realised from their investment where the underlying fund is UK property-rich or has a UK property-rich component. A very significant proportion of investment in such funds is from overseas investors, who prior to April 2019 would have been outside the scope of UK tax and therefore not impacted by any SD P12 issues. We note that this is not an issue that is specifically related to UK-domiciled LP Funds, it is relevant to LP Funds whatever their domicile.

81) Under UK capital gains tax law for partnerships, and specifically SP D12, capital gains tax events can arise where there is a change in partnership profit sharing ratios. When the interests held by investors in a partnership change, for example due to the admission of a new partner, the change in profit sharing ratios can cause deemed disposals for the existing partners, shifts of base cost and accelerated tax charges. This results in partners being taxed at a point in time when no economic return has been received (and when the investor has not yet realised any cash from the investment) and may also differ significantly to the tax charge which would have been levied on the 'true' economic return.

82) In a funds context, this results in complex CGT considerations for partnerships and their investors in situations such as the introduction of new co-investors, subsequent fund closes, or on the operation of profit 'waterfall' arrangements (including in relation to carried interest entitlements). In all of the above scenarios, some investors would see their partnership profit sharing ratio (as a proportion of the whole fund) reduce. However, they have not disposed of anything from a commercial perspective, their partnership capital account would generally remain unchanged, the commercial value of their interest in the fund would generally remain unchanged, and they would generally not receive any cash out of the fund merely as a consequence of these changes. The application of SP D12 in such situations affects the ability of partnerships to operate effectively as fund vehicles for real estate investments.

83) This is of course only an issue for taxable investors, but means that in practice partnerships that wish to be unaffected by the potential complexities and inequities of SP D12 can either only operate for exempt investors, or with a very small number of investors (i.e. as joint ventures).

84) Given the barriers and challenges set out above, we would recommend that a review of SPD 12 and the approach to partnerships is conducted.

85) **SDLT** - is applied on transfers of interests in partnerships that hold UK land. This was an anti-avoidance measure following the extensive use of partnerships as SDLT avoidance vehicles in the mid-2000s. While this anti-avoidance measure was not specifically targeting genuinely widely held funds, it is applied to all transfers of interests in property investment partnerships, and is a significant barrier to setting up property funds in LP form (in particular because the charge applies to gross value of underlying property rather than the economic value of fund interest).

86) **Legal personality** – it would be helpful if there was the option for an ELP to have a separate legal personality e.g. as is the case for a Scottish LP and the Lux SCS. This would enable the LP to be able to hold legal tile of a property.

87) **LLPs** – We would note that LLPs do not currently work for pension funds to invest in real estate. This is because income and gains derived as a member of a "property investment LLP" are not exempt from tax for a registered pension fund. There is no longer any logic to this exclusion as LLPs can be used as a vehicle for investment in real estate by other institutional investors, including life companies.

88) The benefit of the use of an LLP is that it has separate legal personality and can own its own assets, including real estate. This reduces the number of vehicles which need to be established to hold real estate (an LLP can own real estate directly, as compared with an English Limited Partnership owning real estate which typically requires at least 3 vehicles: the partnership, the general partner and one or two nominee companies to hold the legal title).

89) Accordingly, we would recommend repealing section 271(12) TCGA and section 186(2) Finance Act 2004 (and the definition of "property investment LLP" in section 1135 CTA 2010, which would as a result, be redundant).

90) **WHT** - private fund limited partnerships should be able to receive income gross and pay out distributions gross, or net, based on the investor's own status (even if it is distributed indirectly through another partnership).

Chapter 3: The UK's approach to fund regulation

Question 12: What benefit does fund authorisation bring to product providers beyond access to retail investors? Does this benefit vary depending on the specific investor base or investment strategy? What relevance does authorisation of a product have to its appeal to the UK market and to the international market?

91) No comment.

Question 13: Do you have views on the current authorisation processes set out in legislation and how they could be improved?

92) No comment.

Question 14: How do the FCA's timescales for fund authorisation compare internationally? Is there value in providing greater certainty about these timescales? Other than by reducing the statutory time limit, how could this be achieved and what benefits would it bring?

93) No comment.

Question 15: What would you like the QIS structure to enable you to do that is not currently possible? What are the existing impediments to your suggested strategies, and why would the QIS be the preferred UK structure for those strategies?

94) No comment.

Question 16: Do you think that the range of QIS permitted investments should be expanded? If so, in what way should it be expanded, what impact would this have, and would it still be appropriate for sophisticated retail investors?

95) No comment.

Question 17: Do you think that the QIS borrowing cap should be raised or QIS constraints on derivatives exposure should be relaxed? If so, to what magnitude and why? Would this be appropriate for sophisticated retail investors?

96) No comment.

Question 18: Do you agree that the QIS sub-fund structure could be improved? If so, how? Would greater clarity for the segregation of assets between sub-funds via legislation or rules be helpful? Please provide details.

97) No comment.

Chapter 4 – Opportunities for wider reform

Question 19: Do you agree that reforms to enhance the attractiveness of the UK funds regime should focus on appealing to the creation of entirely new funds that have not yet been set up?

98) In order for the UK to bolster its position as a centre for asset management excellence – existing fund structures must be reviewed as a matter of course – with appropriate reforms made which respond to the industry's needs. For that reason we have called for a new asset management government task force who has the remit to respond to the changing needs of the sector as challenges are identified. In addition, where gaps in the market are identified, of course new vehicles will need to be developed – but this should not be at the expense of ensuring existing structures remain fit for purpose and respond to the sector's needs.

Question 20: Why do firms choose to locate their funds in other jurisdictions in cases where the UK's funds regime has a comparable offering, for example ETFs? Are there steps which could help to address this following the potential reforms to the UK funds regime discussed in this call for input, and would the scope to address this vary depending on the type of fund or target investor market?

99) In real estate fund context, particularly funds aimed professional institutional investors, the UK does not offer comparable fund vehicles to those used overseas – and to that end, new UK fund vehicles would be helpful (such as the PIF and other Onshore Professional Funds, as touched on in questions 30-37).

100) There are some cases where a fund would not choose to locate the UK, even where a comparable fund is available – for example:

a. ***Stability of the tax environment***: There have been numerous changes in recent years which have been detrimental to the sector – or rushed through, without sufficient consideration given to the impact on investment fund structures (notably the corporate interest restriction rules and the hybrid rules). This approach to tax changes has gradually eroded investor and fund manager confidence in the UK as a suitable place to set up long term investment fund structures. Therefore, the government will need to change investor perceptions – and re-build the UK's reputation for a stable tax environment.

b. ***Substance in a single location:*** Fund managers will want to be based in the jurisdiction which can best cater to the widest variety of asset classes and investors. Therefore, even where one of the fund vehicles is comparable in the UK, this may not be sufficient to bring the whole portfolio over the UK.

c. ***The tax neutrality of whole structure:*** A fund manager will need to have regard for the ability of the whole fund structure to achieve a tax neutral outcome for their investors (including intermediate investment entities) – therefore the equivalence of the fund entity itself will not be the only consideration.

d. ***The VAT treatment*** - VAT represents a significant cost to UK established funds, in particular those with UK-based investments. Current UK VAT rules such as the existing exemption for management services and VAT grouping regime go some way to mitigate this, however, much more could be done to make the UK a competitive location for establishing funds – see more detail in response to Question 38.

Question 21: Do you agree that reforms to enhance the attractiveness of the UK funds regime should focus on appealing to AIFs targeting international markets? Which markets would be most valuable and what would be the key obstacles to overcome in each?

101) There is scope to significantly simplify the tax outcome of investments in overseas real estate – by guaranteeing that no additional UK tax will be suffered on returns from overseas real estate which are repatriated through the UK.

102) Given non-UK property holdings would generally currently be held in non-UK companies, a general exemption for overseas property income and gains (even if held in a UK company) should be uncontentious – and could generate significant opportunities for new UK investment fund structures to be set up in the UK.

Question 22: Do you agree that new UK fund administration jobs associated with new UK funds would be likely to locate outside London? How could the government encourage fund administration providers to locate jobs in specific UK regions?

103) Fund administration jobs have traditionally been spread across the UK (with hubs in a number of UK cities, including Exeter, Edinburgh) – therefore, we would expect the jobs brought to the UK as a result of the government's current efforts to bolster the asset management sector to continue to be spread across the country.

Question 23: How can the government ensure the UK offers the right expertise for fund administration activity?

104) No comment.

Question 24: Are there specific barriers to the use of ITCs, either from the perspective of firms creating fund products or from the perspective of investors seeking to access them? Are there specific steps which could address these?

105) No comment.

Question 25: Should asset managers be required to justify their use of either closed-ended or open-ended structures? How effective might this requirement be, and what are the advantages or disadvantages of this approach?

106) We believe that institutional investor preferences and needs should drive the decision whether to offer open-ended or closed-ended funds. It is not clear whether requiring an asset manager to justify the approach adopted would serve any benefit, but could add unnecessary administrative hurdles.

Question 26: Should the distribution out of capital be permitted? What types of products would this facilitate and what investment or financial planning objectives would they meet for investors? What are the possible advantages, disadvantages and risks for investors?

107) No comment.

Question 27: How do you consider that such a change might be delivered? Please explain your answer, providing specific examples of rules, how they could be changed, and the effect of the changes.

108) No comment.

Question 28: Do you foresee any issues with the LTAF adopting the current tax rules for authorised investment funds? Would the nature of an LTAF's investments, and the tax treatment of the income it receives in respect of those investments, mean that the current rules for authorised funds lead to tax inefficient outcomes?

109) We support the introduction of an LTAF – and recognise the importance of ensuring that we have appropriate fund vehicles to channel increasing levels of DC (defined contribution) pension savings. We support the comments from the Association of Real Estate Funds in relation to this question.

Question 29: Are there any other tax considerations, outside of those that follow from the adoption of the current tax rules for authorised funds, that will be important to the success of the LTAF? Please explain your answer.

110) No comment.

New Unauthorised Fund Vehicles

Question 30: How would each of the proposed unauthorised fund structures add value alongside existing authorised and unauthorised UK fund structures, including the QIS? Would they bring value alongside each other? Would they bring unnecessary complexity? What would each structure allow fund managers and investors to do that they are unable to do currently in the UK regime? Please address each proposed unauthorised structure separately, and indicate which of the proposed unauthorised structures you consider most important.

Question 31: Would these unauthorised structures support the government's work on facilitating investment in long-term and productive assets, as outlined in Chapter 1?

Question 32: How do you think the government could best achieve consistent branding for UK fund structures which target only professional investors?

Question 33: Do you think that these unauthorised structures should be unregulated collective investment schemes? If you consider any 'light-touch' authorisation necessary or desirable, what do you understand this term to mean and what form could it take? Why would it be beneficial for investors, and how could it be explained to them in a way that avoids confusion with the regulatory assurances of fully-authorised structures?

Question 34: Do you think these structures should have flexibility on whether they are open-ended or closed-ended? Should they have flexibility on whether they are listed or non-listed? How important is this?

Question 35: Do you think these vehicles should or could be implemented as part of existing structures set out in legislation? Please provide details. If not, please explain why not.

Question 36: Are there any specific tax treatments that would be either necessary or desirable to support the successful introduction of new unauthorised fund vehicles in the UK? Please provide detail of how and where this is the case.

Question 37: Are there any interactions with wider tax policy that the introduction of new unauthorised vehicles would need to navigate, in order to avoid unintended consequences?

111) We support the response of the Association of Real Estate Funds in relation to questions 30 to 37. We believe there should be various funds available in the UK which will meet the needs of different types of investors depending upon their investment requirements. At present, there is clearly a gap in the UK suite of fund vehicles for unauthorised funds aimed at professional or institutional investors – in particular, ones that can be used for joint venture arrangements, which are very common for real estate investment. To that end, we are supportive of the UK Funds Regime Working Group's proposals to create a suite of Onshore Professional Funds – which would include a partnership vehicle, a corporate vehicle, and a contractual scheme vehicle i.e. PIF.

112) We would note that partnerships in particular are very popular and familiar vehicles for investors – particularly in joint venture arrangements. In addition to exploring the new 'Onshore Professional Fund' options, we'd reiterate the importance of addressing points in question 11, which could help make English Partnerships more viable fund vehicles.

113) In respect of all new non-authorised fund vehicles being considered, it will be helpful to acknowledge the challenges and difficulties for some real estate funds in using the Co-ownership Authorised Contractual Scheme Funds (CoACSs) when they were introduced. The subsequent guidance and legislation which enabled the ACS structures to be used for real estate funds will be relevant to consider in the design of these new fund vehicles.

Question 38: Are there other things government should consider as part of this review of the UK funds regime, or proposals for enhancements to the UK funds regime which the government has not included in this call for input? If so, how important are they and how would you like to see them prioritised in relation to the proposals explored in this call for input?

114) As noted in response to question 1, the Government must acknowledge the ambitious and long term nature of the challenge here – and bring together a dedicated task force which has the remit to be responsive and agile in order to support the sector's needs. This task force will need to bring together expertise from a number of areas – including from HMT, HMT and BEIS. The specific workstreams of this this task for will naturally evolve over time – but we consider the areas below to be a priority:

a) **Asset Holding Company regime**: The success of the new tax regime in the UK to support tax efficient repatriation of profits through UK fund structures will be fundamental to this Funds Review and the Government's wider ambitions to bolster the asset management sector in the UK. In order to successfully attract new fund structures, the new Asset Holding Company regime must be simple to understand and administer.

b) **Wider changes to the UK tax rules still needed:** Our original response to the AHC consultation urged the government to consider helpful changes to the UK tax rules more broadly, notably SSE, the tax on overseas property returns, and the approach to WHT on interest. We hoped these changes would help accommodate alternative investment structures, without creating a cliff edge for different commercial structures which fall short of any eligibility criteria. Given the proposals for the AHC regime are now intended to include strict eligibility criteria, we consider that a review of some of the broader UK tax rules which have a significant impact on investment structures will still be helpful to support the government's ambitions to bolster the UK's position as a centre for asset management services.

c) **VAT of fund management fees:** The VAT applied to fund management fees will also be critical to the success of the investment management sector in the UK – and we look forward to engaging in a separate consultation on this in due course. As noted in the call for evidence, assessing the correct VAT treatment is currently complex, leading to high administrative burdens and significant volumes of litigation – as well as significant VAT leakage for some funds. Leaving the EU presents an opportunity to deliver simplifications and other potential reforms to improve the competitiveness of the UK – and we set out a number of options below, which should be considered as part of the forthcoming review.

i) **Zero rating:** The introduction of a zero-rate for fund management fees would significantly reduce tax-leakage on fund set-up and ongoing administration costs and serve to bring the UK more in line with competing jurisdictions**.**

ii) **Broader exemption:** The widening of the existing exemption for fund management to include a wider range of funds (notably unauthorised funds) and services (for example, research). This presents a less attractive alternative to zero-rating as it creates irrecoverable VAT costs for the manager which are ultimately passed onto the fund and create particular inefficiencies where the fund in question has a high recovery rate.

iii) **The introduction of an option to tax for fund management services:** This would be more attractive than blanket exemption, especially in the case of REITs with opted commercial property or overseas investments.

iv) **VAT grouping:** Changes to the VAT grouping rules to benefit a wider range of funds. Currently, the control requirement and joint and severable liability create barriers to the inclusion of funds in VAT groups with the manager. Eliminating these obstacles would reduce VAT-leakage on management fees and significantly reduce admin costs associated with multiple individual VAT registrations.

This is not an exhaustive list – there are a number of complications with the existing approach for charging VAT on fund management fees in the UK which will need to be addressed to simplify the VAT treatment for funds in the UK. To that end, we would reiterate the importance of a wider consultation on this area – and look forward to engaging in due course.