# SOVEREIGN IMMUNITY FROM DIRECT TAXATION

## CONSULTATION RESPONSE

**PREPARED AND SUBMITTED BY**
Rachel Kelly
Assistant Director (Finance)
E: rkelly@bpf.org.uk

# INTRODUCTION

The British Property Federation (BPF) represents the real estate sector – an industry which contributed more than £107bn to the economy in 2020 and supported 2.3 million jobs. 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.

As owners, investors and developers of places up and down the country, the real estate sector has a hugely important role to play in supporting the Government's policy aims around decarbonisation and levelling up. Both of these long term projects will require significant private sector capital investment, sustained over a period of many years, if they are to be successful.

A significant amount of investment in UK real estate comes from institutional investors who value the stable, long-term returns that property investment can deliver. These include sovereign investors who have invested heavily in UK property, both on their own and in partnership with other investors. That investment can be direct or indirect, with REITs and property funds providing sovereign entities with a means of combining their capital with the experience and local knowledge of UK-based property professionals.

The UK tax system recognises their importance as an investor, with sovereign entities classified as "qualifying" (or good) investors over a number of investment regimes, including most recently the new Qualifying Asset Holding Company ("QAHC") regime and, in 2017, changes to the Substantial Shareholding Exemption (SSE) to attract institutions, including sovereign entities, to establish investment platforms in the UK.

The Government's consultation on policy design "Sovereign immunity from direct taxation" (the Consultation) set out the government's plans to codify the meaning of sovereign status whilst at the same time effectively removing sovereign immunity. As the Consultation makes clear, the most significant impact of the proposal will be on investment by sovereign entities in UK real estate, with both UK property income and gains being brought into the scope of UK tax.

We are grateful for having had the opportunity to meet with officials from HM Treasury (HMT) and HM Revenue and Customs (HMRC) to discuss the Consultation and, from those discussions, understand (and welcome) that the Consultation invites stakeholder views on the policy proposal itself and not just its design. Our response has therefore been drafted on that basis.

# EXECUTIVE SUMMARY

Our detailed responses to the consultation questions are set out in the appendix. We have summarised our primary areas of concern below:

**1. Impact on investment by sovereign entities**

The UK has historically sought to create an attractive tax environment for sovereign entities in order to attract long-term capital to this country. The proposal made in the Consultation to restrict sovereign immunity to a withholding tax exemption on interest therefore comes as a surprise and sends an odd signal to such investors at a time when significant and sustained investment will be needed in town centres across the country, and to decarbonise the built environment.

We note that a full assessment of the impact of this proposal is yet to be carried out, but are concerned that, notwithstanding the many benefits that the UK has as an investee country, the extent of the change proposed could lead to sovereign investors re-allocating their funds to other jurisdictions competing for the patient, long-term capital they provide.

**2. Timetable and Transition**

The Consultation states that the effective removal of sovereign immunity will take effect from 1 April 2024, a period of 21 months from the date of publication. This is not a "reasonable lead in time" for a change of this nature, given in particular that it will impact not only on new investments by sovereign entities but also on existing UK assets. Non-resident company landlords, who were existing UK taxpayers, were given three years to prepare for the move from income tax to corporation tax. If the government's response to the consultation is to confirm it is going ahead with the proposal, the commencement date should be pushed back at least a year to April 2025 to allow sovereign entities (and those they invest with and in) time to prepare for their new status.

As the Consultation acknowledges, the status of investors as sovereign immune underpins a number of the tax regimes relevant to investment in UK real estate (including Real Estate Investment Trusts (REITs), Qualifying Asset Holding Companies (QAHCs), and collective property funds that have made exemption elections). The Consultation contains no detail on the possible changes that the government considers need to be made to these regime, but references "a need for care". We agree that care is needed — the issues are complex, and getting it wrong risks significant costs for both sovereigns and their co-investors. Sovereign investors and their partners need time to adapt - when Australia changed its rules on sovereign immunity in 2019, it committed to a seven year transitional grandfathering for existing investments: the UK should do the same.

**3. International Comparisons - REITs**

The Government states that it is looking to reform the UK rules in this area in line with the "international mainstream" - referencing the US and Australia in particular. However the proposal in the Consultation does not take account of the approach both those jurisdictions apply in providing specific relief for real estate investment by sovereign entities. In the US, exemption is maintained where a sovereign entity has a non-controlling interest in a US REIT on the basis that this is "passive" investment; in Australia, the managed investment trust ("MIT") regime allows a sovereign investor access to beneficial tax treatment on real estate where certain conditions are met. There is therefore a need for further examination of how other jurisdictions approach sovereign immunity to ensure the UK is not uncompetitive.

### 4. Pension Funds

The Consultation suggests that (some) foreign government pension funds that currently benefit from sovereign immunity may be able to continue to access exemption under existing UK rules for non-UK pension schemes. In practice, the UK rules for overseas pension funds and registering as a pension scheme are very unlikely to be available to a foreign government pension scheme. If the policy intention is that foreign government pension funds should have a similar treatment to UK pension funds (rather than other non-resident investors), the legislation should therefore provide for a specific sovereign pension fund exemption.

### 5. Stability

Investors, particularly those like sovereign investors that invest for the long-term, value stability, including with tax matters, in order to be able to model and predict the return their investments will provide. This proposal follows on from almost ten years of material changes to the tax rules affecting UK real estate. We recognise the government's desire to keep the tax system under review, but constantly changing the rules in this way creates uncertainty and runs counter to promoting the kind of stable tax environment that is so important for fostering long term investment.

Our detailed responses to the consultation questions are contained within the appendix. If you have any questions, or would like to discuss our response in further detail, please contact Rachel Kelly, Assistant Director (Finance), rkelly@bpf.org.uk.

# Appendix: Response to consultation questions

## Chapter 3: Eligibility and scope

**Q1. Do you have any comments on the proposed eligibility for sovereign immunity, and the proposed approach to exempting UK income?**

*Eligibility*
In our view, codifying the meaning of a sovereign immune person will provide certainty and ensure transparency. We consider that it would be helpful to do this even if the changes to immunity are not taken forward.

In terms of who would be eligible for sovereign immunity, please see responses to questions 3 and 4 below.

*Proposed Approach - general*
In Chapter 1 of the Consultation, the government states that it considers:

> "that there is a strong case for the UK to make the types of income eligible for sovereign immunity more targeted. Like other countries, the UK continues to see a case for having a more limited exemption that applies to certain types of investment income and ensuring that the exemption is appropriately targeted in line with its aims, whereby it is proportionate while continuing to both signify and facilitate the UK's openness to sovereign investment." (page 9)

The proposal is that the UK exemption should be refocused on income "from investment activity and specifically investment of a more passive nature" such that, if the proposals proceed, the only exemption based on sovereign immunity would be limited to withholding tax on interest—save where the interest is linked to a UK trading activity. (As the government acknowledges, no provision is needed for dividends as such are exempt from withholding tax in any event under existing rules.)

The discussion in Chapter 1 as to the background to the proposal references the distinction of the UK in extending exemption to "commercial activity", referencing (by way of comparison) the position in certain other jurisdictions. In Chapter 3, the government references a "growing global trend towards a more targeted form of immunity that does not cover commercial activities and, either as part of or in addition to that, limits the exemption to more passive and portfolio-like investments" which it says excludes real estate.

We do not agree that "passive and portfolio-like" investments automatically exclude real estate.

The nature of real estate as an asset class means that it can be held by an investor as an investment or as part of a trading activity (for example, property development). Whether an activity is investment or trading is a factual question, based on the "badges of trade". The UK tax system effectively operates on a basis that "trading" is active, and investment is "passive" (linked in part to the source/schedular system which means that separate rules apply to different types of income in any event).

The UK tax system has historically seen property investment as "passive" (we note here, by way of example, that the (general) substantial shareholding exemption can only apply to disposals of "active" trading companies). Clearly that "passive" investment, particularly where undertaken by or on behalf of institutional investors (such as sovereign investors (SIs)), will be run as a commercial activity and be intended to generate a profit—but that does not necessarily mean that it can be regarded as comparable to a trade.

This is particularly the case where, rather than directly acquire a UK property (and therefore itself carry on a property business), an SI invests on a portfolio-like basis in real estate – whether by acquiring a minority stake in a collective investment vehicle that itself invests in property (generally referred to in this response as a "property fund") or in a UK REIT. Here the "commercial activity" is carried on the property fund/REIT, with the SI simply looking to benefit from the returns generated from the underlying assets as a passive investor: here, "passivity" of the SI is as a result of the fund/REIT having control of the management of the property business whereas the influence of the SI is as a result of the ownership interest in the relevant entity as an investor). In some cases, the UK has, as a matter of policy, determined that the person that carries on that commercial activity should itself be exempted (e.g. under the REIT rules or, in relation to chargeable gains, Schedule 5AAA Taxation of Chargeable Gains Act 1992 (TCGA)), with any liability to tax at investor level — but those regimes nevertheless respect the difference between carrying on the activity and simply receiving returns from it.

We therefore consider that, if sovereign immunity is to be refocussed as the Consultation proposes, a distinction can (and indeed should) be made between the different types of real estate investment that an SI may undertake. (Examples of those different types of investment are discussed in response to question 27.)

In this context, there is precedent for such a distinction in the treatment of SIs (as compared to other investors) in some of the jurisdictions that the Government reference in Chapter 1 (although these distinctions are not referenced in the Consultation). For example:

Australia

As the Consultation notes, Australia changed its rules relation to SIs in 2019. We understand that the objective was in part to "level the playing field" as Australian institutional investors (such as pension funds) are taxable on investment income.

Under the new rules, sovereign immunity continues to apply where an SI has a portfolio holding in the relevant structure (generally meaning < 10%). Immunity extends to withholding tax on both dividends and (third-party) interest and on capital gains on disposal of that holding.

In relation to real estate, Australia has a specific regime for collective investment (the managed investment trust (MIT) regime). A MIT can hold real estate and, if it does, will benefit from exemption on income and gains from it. Although when it distributes profits to investors, a withholding tax applies, an SI benefits from a withholding exemption, provided it is a portfolio investor (in addition to certain other conditions). This means that the after-tax return of a portfolio SI is better than that of other non-resident investors who are subject to tax at 30%.

United States

We understand that the US exemption for SIs covers "passive" income where the SI does not have a controlling interest (generally, an interest < 50%, but there are other tests to look for "effective control" other than through share ownership). If the SI engages in a US trade or business however, its access to immunity on passive investments can be lost—in practice therefore we understand that 'while SIs can hold non-controlling interests in companies which undertake commercial activity, they are not themselves permitted to undertake such activities (either directly/in a transparent structure, or within a controlled corporate subsidiary).

"Passive income" for US tax purposes includes most capital gains. Here, SIs benefit from a specific exemption from US tax on gains on disposal of US real estate-rich companies which is unavailable to other non-residents.

Where an SI invests in a US REIT, (income) dividends paid to the SI are exempt from US tax; a capital distribution (of gains from the sale of US real estate would however be taxable). A sale of shares in the US REIT would benefit from the exemption for US real-estate rich companies referenced above.

Both Australia and the US distinguish between different types of investment in real estate, whether direct, indirect, portfolio or controlling—and, in particular, confer a more beneficial tax treatment on SIs that invest (indirectly) in their domestic real estate than is available to other non-resident investors.

Given that the government states that one of its objectives is "to bring the UK in line with the international mainstream", we ask the government to revisit its consideration of other countries' SI regimes to enhance its understanding of the detail of how those regimes operate in relation to real estate, with a particular focus on Australia and (particularly in relation to the position of SIs that invest through REITs) the US. This is because, in our view, any new UK rules in this area should leave an SI in no worse a position than they would be investing in a comparable investee jurisdiction. Otherwise the UK could continue to be "out of step" with the international mainstream in a way that could be prejudicial to its attractiveness to SIs.

In addition, in assessing other countries' regimes, the government should do so holistically (hence, in relation to Australia, looking at MITs and taking into account of other countries' treaty networks (for example, France, Italy and China)) as well as the investment environment in those countries (and in particular the role and extent of inbound SI investment) that may have shaped the approach taken to taxing SIs.

We would suggest that applying a 'simple' comparison of SI exemptions and regimes themselves – without a side-by-side comparison of the role and extent that sovereign investment has to play in the economy and investment landscape (both currently, and in the future) – is an oversimplification that could otherwise result in erroneous conclusions being drawn.

In particular, whilst the tax exemptions offered in many overseas countries may not necessarily be as broad (or may be limited by reference to e.g. ownership percentages) in some cases as is currently the case in the UK, where the position differs, we understand that this may be because the macroeconomic role of foreign sovereigns as investors in those countries is perhaps different from the current UK position (where, as noted above and in our response to question 32, sovereign capital has historically been a significant source of inward investment in the UK built environment and infrastructure). For example, the USA has a very large domestic investor base, and, similarly, Australia has both its own sovereign wealth fund and a number of very large superannuation funds (combined with a comparatively small domestic asset base for investment). As a result, foreign, including sovereign investment may play a less important role in these economies than in the UK.

For these reasons, a comparison with other countries based solely on the 'headline' SI regime does not provide the full picture because it ignores both the aforementioned differing economic contexts, as well as the interaction with other local tax rules

Finally, the table set out on page 8 of the Consultation states that sovereign immunity is not available in Spain. We have been informed by members that in two recent decisions the Spanish Supreme Court said that sovereign immunity was available for overseas SIs on returns from investments in the same way it is available to Spanish sovereign entities: we have no other information on this but considered we should bring this to your attention.

*Proposed approach - "level playing field"*
The Consultation references as one of the policy rationales for the proposal the need to "seek to provide a level playing field" among investors, referencing the recent reforms to the taxation of non-residents who invest in UK real estate (in Finance Act 2019).

Under the proposal as set out in the Consultation, some (but not necessarily all — given the comments on page 28 concerning pension funds) SIs will become taxable and so be within the scope of UK tax in the same way as any other non-resident.

However, there will still be areas in which the playing field is uneven (some created by the proposal). For example, in relation to non-UK government pension funds, it is unclear whether the policy aim is to ensure level treatment as compared with UK pension funds or against non-resident investors generally. If the former, that would suggest that SI pension funds that meet relevant criteria as to purpose will continue to be exempt. However, as set out in our response to question 28 below, we do not consider that (many) SI pension funds will be able to access exemption under the existing rules for overseas pension funds (rendering them fully taxable absent specific provision).

In addition, a number of the UK's bilateral tax treaties provide exemption (or relief) against withholding on dividends where the recipient is an SI. This means that where two or more SIs invest in a REIT, each could be taxed differently because of treaty negotiations that were undertaken when immunity was a "given" (such that the availability of treaty relief was effectively academic). This would be the case where each SI holds a minority interest in the REIT as well as where its interest was more material (i.e. where the REIT was closely held by institutional investors). Treaties are a matter of bilateral agreement and so changes between them are expected, but the proposal in its current form could lead to a different form of (very) uneven playing field as between different SIs given the UK's current treaty network (see response to question 30).

Finally, as the Consultation acknowledges, under the proposal an overseas sovereign entity will be taxed differently to a UK sovereign entity.

*Proposed approach - interest withholding*
The proposal as set out in the Consultation is to replace general sovereign immunity with an exemption from withholding tax on interest.

The Consultation states that "Payers of UK sourced interest to sovereign entities would be relieved of their withholding tax obligation, on receipt of authorisation by HMRC" (page 13).

At this stage in the consultation process, there is no detail as to how this authorisation process would work. We assume an application would need to be submitted to HMRC by the payer, including information as to its lender (the SI). It will be important that whatever process is decided upon is administratively straightforward and timely (so that the risk of delays in authorisation as a result of HMRC resourcing constraints—as can from time to time occur in relation to treaty claims—can be minimised). The practicalities of how such an exemption would work are, in some ways, as important as the exemption itself. Given that an SI will be required to apply to HMRC for status confirmation, one possibility would be to model an exemption on the QPP (Qualifying Private Placement) rules (with the HMRC confirmation letter required alongside a declaration); alternatively a form of Double Tax Treaty Passport (DTTP) scheme for SIs could be established. As some SIs may be entitled to claim exemption under a tax treaty in any event, similar issues apply in relation to processing treaty claims.

**Q2. Do you have any comments as to the best way to define what persons or manifestations of the State should be eligible?**

On the treatment of government pension funds, we note that under some tax treaties, a government owned pension scheme is specifically listed as an example of a government entity entitled to exemption/relief (for example, the UK/Norway tax treaty). We therefore consider that government pension schemes should continue to be eligible for sovereign immunity, particularly given the limitations of existing regimes for overseas pension funds (see response to questions 28 and 29 below).

**Q3. Should the government include controlled entities as eligible for sovereign immunity in any new legislation? If so, how should they be defined?**

Yes.

We anticipate that, if the proposal is implemented, SIs are likely to choose to hold their investments in companies (although the tax treatment would be broadly the same, this would mean the company, and not the SI, has reporting obligations and, to the extent that the SI sought to introduce debt into its funding arrangements, there would be commercial and legal benefits from ring-fencing investments in individual companies).

Given that any such company would be within the charge to corporation tax on its property business profits (and subject to the corporate interest restriction which, where financing costs exceed the de minimis, would limit deductibility of interest on related party debt), we see little Exchequer risk in extending sovereign immunity on interest withholding tax to companies controlled by SIs. In any event we note that, depending on the form of the company, it may be that HMRC would regard it as an emanation of the SI in any event and so entitled to immunity in its own right—however a statutory exemption would provide certainty for SIs, avoid the need for legal analysis of the relevant company and also ensure fairness as between SIs (particularly as some of the UK's bilateral tax treaties define SI controlled companies as government entities in any event—e.g. UK/China treaty).

In terms of defining a SI controlled company, we would suggest that either of paragraph 33 Sch 5AAA TCGA or paragraph 11 Sch 2 FA 2022 would provide a useful precedent such that the test is basically "wholly or almost wholly" owned by one or more SIs, with account is taken of both direct and indirect ownership given that the company may be part of a "stack". However the meaning of "almost wholly" may need to be revisited (as discussed in relation to the REIT listing condition relaxation, an investment manager advising the SI may need to co-invest (so it itself assumes "risk" in the investment) and that co-investment, although minimal, could exceed the 1% "other" interest allowed by paragraph Sch 5AAA TCGA).

**Q4. Should foreign government pension schemes be specifically excluded from eligibility from Sovereign immunity, since existing alternative exemptions from tax on their income and capital gains may be available to them?**

No: see response to questions 28 and 29.

**Q5. Do you have any comments on the proposed approach to sovereign non-natural persons, under Corporation Tax?**

The Consultation references "generally" treating sovereign non-natural persons—that is, those that are not individual human beings (natural persons)—will generally be treated as non-resident companies. It does not comment on the possible exceptions to this.

Although the nature of such SIs would support their being regarded as akin to a corporate, consideration would need to be given to how far deemed company status would apply (within the context of the detail of UK tax reliefs). For example, would an SI be a "ultimate parent entity", could it be a "company" for the purposes of benefitting from the Substantial Shareholding Exemption (SSE) directly, and would it be a member of a group? Where an SI holds an interest in a REIT, would it be subject to the holder of excessive rights provisions (under condition B or C)? It would be helpful to understand the government's view as to the extent of any SI company "fiction" before commenting further.

In relation to grouping matters, see also response to question 8.

**Q6. Do you have any comments on the proposed approach to sovereign natural persons, under Income Tax and Capital Gains Tax?**

No comments.

**Q7. Do you have any comments on the proposed commencement date? Are there any practical issues that make this date inappropriate?**

The Consultation sets out a proposed timetable for the new rules under which they would come into effect from April 2024 (with draft legislation expected to be published in July 2023 for inclusion in Finance Act 2024 (assuming the current tax policy timetable of an autumn Budget/Finance Bill continues)). The government says this is a “reasonable lead-in time”: we do not agree for the following reasons:

(a) the timetable set out in the Consultation is in relation to a proposal that “will” happen. At roundtables with stakeholders to discuss the proposal, officials have emphasised that the Consultation is nevertheless at Stage 1 of the Government’s tax policymaking process (i.e. no policy decision has been made as yet). It is therefore unclear when that decision would be made. Realistically, a lead-in time (i.e. a period in which the affected taxpayers can plan for the change and, where relevant, implement new processes for tax reporting) can only start when there is certainty that change will happen - anything else risks wasted time and wasted costs. Even if 21 months is a reasonable lead-in time, then those 21 months should start only when the decision to proceed with this measure is formally announced—which would not be April 2024.

(b) as the Consultation notes, the proposal represents a significant change for SIs given that they will become subject to UK tax for the first time on their investments. The announcement that non-resident company landlords would become subject to corporation tax was similarly significant (though such companies were already within the charge to UK tax). There, the first consultation was published in March 2017 with commencement on 6 April 2020 (i.e. 3 years later). Although we recognise the differences in the types and number of taxpayer affected by the two measures, the adjustment to corporation tax (and indeed the need to appoint UK tax support to advise on and prepare for the change) is the same.

(c) in addition, the proposal does not just affect SIs, but also investment vehicles in which they have an interest given the relevance of qualifying investor status (to QAHCs, REITs, funds that have made an exemption election etc). It is unclear from the Consultation what (if any) changes will be made to these regimes if SIs lose their immunity (or indeed when specific proposals will be made available for consultation). As highlighted at stakeholder roundtables, the issues here are complex and need time to be worked through thoroughly to minimise the risk of unintended consequences (for the Exchequer, the vehicles and other investors in those vehicles). Further, once policy has been decided (and draft legislation published), those vehicles will need a reasonable lead-in time—particularly if their own tax status could be adversely affected (eg the conditions for REIT status are no longer met).

(d) As SIs are likely to have structured investment in UK real estate to engage their immunity, we anticipate that existing structures would need to be reorganised if SIs become taxable. In some cases they may look to sell a particular investment (or even be required to do so—e.g. if their continuing investment in a REIT were to jeopardise its status). An early (and hard) commencement risks SIs being forced to make decisions at the "wrong" time in the investment cycle. One possible solution here would be to allow for grandfathering of SIs with respect to existing investments for a reasonable period. We understand that, in Australia, following consultation, its government legislated for a 7 year transition period—which ends on 1 July 2026. Given the scale of SI investment in the UK (and noting that a large proportion of that has historically been in real estate), we would recommend that the government consider providing for transitional grandfathering for a similar period, allowing those SIs that choose or have to divest assets to be able to do so by reference to market conditions (rather than by an arbitrary date). Such a measure would allow SIs to prioritise planning for new investment, rather than having to divert resources to reorganising existing investments within a narrow window.

Taking account of the above, we recommend that, if the government decides to proceed with this proposal, the commencement date is deferred until at least April 2025 and that additionally the government introduce a time-limited grandfathering period by way of transition for existing investments—ideally, a 7 year period as applies in Australia. Further, the extent of any transitional and/or grandfathering measures should be announced at the same time it announces its decision to proceed with the proposal to provide SIs with certainty as to the timescale in which restructuring decisions need to be made (and implemented) - see further our response to question 34.

**Q8. Are there any other transitional arrangements that should be considered? If so, why?**

We ask the government to consider the following arrangements:

*Grandfathering of existing investments for specified period:*
See response to question 7 above. As mentioned, Australia introduced a 7 year transitional period in which an SI was able to continue to benefit from immunity on existing investments. This would mean that an SI was not disadvantaged by the change to its status happening at the "wrong" time in the investment cycle but was able to take into account market conditions in deciding how to adjust to the change, particularly in relation to any resulting sales of investments..

If such an approach were taken, some of the measures listed below may not be required.

*Transitional relief to allow transfer of asset to wholly-owned company*
As above, we anticipate that some SIs may seek to restructure the way they hold their real estate investments. Although a disposal by an SI of an asset prior to commencement would not give rise to a chargeable gain (as the SI is exempt), as the SI may not, on general principles, be a body

corporate, the SI would not be able to avail itself of any group reliefs (for example, stamp duty on a transfer of REIT shares and/or SDLT/LBTT/LTT on a sale of property or an interest in a property-owning partnership). Similarly, and taking account of questions 9 and 10, a disposal by way of restructuring would "fix" base cost within the transferee at then market value (as s171 TCGA would not be applicable): this results in rebasing prior to commencement, without the ability to elect to use original base cost (see response to questions 9 and 10). If the SI waited until after commencement to transfer a property to a company, it is unclear whether s171 TCGA would be applicable (the Consultation refers to SIs "generally" being treated as non-resident companies but does not reference how grouping rules would apply).

We therefore recommend the inclusion of transitional rules to allow an SI to transfer an existing investment to a company wholly (or almost wholly) owned by it on a tax neutral basis, and in particular allow the transferee company to inherit the rebasing options that would have been available to the SI had that transfer not taken place—i.e. a stand in shoes approach. Those rules should allow such transfers before, as well as after, commencement (we would anticipate that there would therefore need to be a specified period in which this particular relief could apply). Further, such relief should differ from "normal" group reliefs as there should be no degrouping charges should the transferee be sold within a 3/6 year period: here, if the company is sold, as it would be UK property rich, the SI would be taxable on any gain on that sale in any event.

*Transparency election: ability to revoke*
Under paragraph 8 Sch 5AAA TCGA, entities such as Jersey property unit trusts (JPUTs) can elect for tax transparency for capital gains (so they are taxed as a partnership). An election once made is irrevocable (paragraph 9 Sch 5AAA TCGA).

Where one or more SIs invest in real estate through a JPUT, they may have consented to a transparency election given it would allow them to engage their exempt status. Had the SI then been taxable, it may not have made that election. We therefore ask for consideration to be given to allowing an election to be revoked: we recognise that this may not be seen as straightforward given practice (SP D12) concerning determination of base costs but (i) the ability to revoke could be limited to JPUTs where SIs had control as at the date of the election and remain as investors at commencement, (ii) all unitholders would need to agree (as for the making of the election and (iii) the revocation would only take effect in relation to assets held on commencement (and so not impact past disposals, if any.

*QII SSE: "Inside" Rebasing*
See our response to question 12.

*REITs and PIDs*
PIDs (in relation to property income profits) are payable in respect of profits arising in an accounting period, and as a result will (at least in part) be paid after the end of that period. A SI could therefore

receive a PID after commencement that is paid in respect of property business profits arising at a time it was entitled to immunity. Given the REIT rules prescribe the amount of profits to be distributed for an accounting period (so it will be clear to what period a PID relates) we ask the government to consider grandfathering PIDs that are paid in respect of accounting periods ending on or before commencement (thereby respecting the effective transparency of the REIT regime).

*Loan relationships/CIR-anti-avoidance provisions*
In restructuring ownership of existing property assets (by transferring ownership to a wholly owned company), we anticipate that the SI may look to secure funding by way of debt (with interest relief offsetting taxable rent).

Within the loan relationship rules, and also CIR, anti-avoidance provisions can apply to restrict relief for interest where arrangements are entered into with a main purpose of obtaining a tax advantage (e.g. s441 CTA 2009 and s461 TIOPA). We recommend that the legislation for the proposal ensure these provisions do not apply where a loan is advanced in connection with restructuring by SIs as a consequence of the change in their tax status.

In addition, we would also like to highlight certain practical issues, generally linked to compliance, that should also be borne in mind.

*Non-Resident Landlord (NRL) status*
As the Consultation states, where a SI holds UK property directly (or through a tax-transparent entity) it will receive rental income subject to withholding at 20% unless it registers for gross payment. We understand that currently Sis can receive rent without withholding on the basis of their sovereign immunity (and so have not had to register under the NRL Scheme). They will therefore need to apply anew under the NRL Scheme to be able to continue to receive rent free of withholding.

It is therefore essential to ensure that the transition to the NRL Scheme is managed so that it is seamless as possible: we consider this will involves both communications policy (with, as happened with April 2020 changes for non-resident company landlords, HMRC contacting SIs directly in advance to explain the different applications that need to be made) and sufficient HMRC resourcing to ensure that registrations (and, in response, the provision of UTRs) is done promptly (we mention this as we understand that there were issues concerning the issue of UTRs to taxpayers following the NRCGT changes).

The need for this process to be dealt with promptly is particularly important should the corporation tax rate be reduced to below the basic rate of income tax, a SI (or a non-UK company owned by the SI) receiving rent net of withholding because the relevant registration forms have not been processed may be overpaying (and any refund would be deferred until after submission of its first corporation tax return). Further where the SI has invested collectively through a (transparent)

property fund, the terms of any financing are likely to require gross rental payments—and unless registration is confirmed, there is a risk of a breach of financing covenants.
In this context, a change to the taxation of SIs may offer an opportune moment to revisit the NRL Scheme administration, and in particular to consider whether there is a means by which, where an entity is registered for UK tax, the application under the scheme for any new properties could be made simpler (noting here, by way of contrast, the role of the DTTP Scheme in facilitating treaty claims for interest—albeit we recognise that the liability of a non-resident recipient of rent is very different to that of a recipient of interest, there may nevertheless be some administrative cross-over).

*Interest withholding*
As for the NRL Scheme, it will need to be ensured that authorisations for payment of interest without withholding are processed by HMRC on a timely basis so that interest can continue to be paid free of withholding.

*Quarterly instalment payments*
We would recommend that the application of the QIPS rules to SIs is deferred for a minimum of one accounting period (as provided for under Schedule 5 Finance Act 2019 when non-resident company landlords became chargeable to corporation tax).

If the proposal is taken forward, we recommend that the government generally revisit the transitional issues it considered in relation to non-resident company landlords moving to corporation tax, as some of these may be equally relevant to SIs ceasing to be exempt.

**Q9. Do you have any comments on the transitional arrangements in respect of capital gains? Do you see any issues or complications arising with respect to rebasing which need to be addressed?**

**Q10. Would automatic rebasing for all sovereign persons produce unfair results? If so, what mechanism do you think should apply to mitigate these?**

Mandatory rebasing on an arbitrary date risks an investor ultimately being taxed on a gain that is not reflective of economic reality (particularly if market conditions are challenging at the time the rebasing occurs).

Taking account of the government's policy aim of ensuring a level playing field between SIs and other non-resident investors, we consider that SIs should benefit from the same approach to rebasing as applied to non-residents within Part 2 of Schedule 4AA TCGA (i.e. rebasing at the commencement date with the ability to elect to use actual base cost instead).

## Chapter 4: Other tax consequences

### Q11. Do you have any details on the scale of foreign sovereign investment conducted through such holding and fund structures?

No. Although individual REITs and property funds should have information as to their own investors, we are not aware of any publicly available sector-wide data.

In relation to REITs, given the different ways an SI may choose to invest—whether by way of a minority stakes in one of the larger listed REITs or by way of a material holding in a REIT established as a result of the Finance Act 2012 changes to the non-close condition—it is not possible to extrapolate any information from individual REIT members with any accuracy. We note that HMRC may have (some) information about the extent of SI investment into REITs in connection with claims to recover withholding tax from PIDs (although the holder of excessive rights rules may impact accuracy of such data).

However we would note that research carried out by the IPF on The Size and Structure of the Property Market for calendar year 2020[1]shows:

- direct ownership of UK commercial property by SIs accounts for around 5% of UK commercial property, representing £28bn of assets)
- direct ownership of UK commercial property by UK REITs accounts for around 15% of UK commercial property, representing £76bn of assets (and SIs will represent part of that investment)
- direct ownership of UK commercial property by UK and Channel Island based collective investment vehicles account for a further 16% of UK commercial property, representing £83bn of assets (and, although the IPR research indicates that the main investors in these funds are UK institutions, we anticipate that SIs may also invest in such vehicle)
- direct ownership of UK commercial property by overseas funds account for a further 9% of UK commercial property, representing £47bn of assets (and we would again expect SIs to be investors in such funds)

By way of comparison, the IPF research puts direct ownership by UK pension funds at £43bn (representing 1.8% of total pension assets).

We also note that, in evidence to the International Trade Committee's inquiry into FDI, Diego López, Managing Director at Global SWF said that QIA, GIC and the Norwegian SWF are responsible for two thirds of SI investment in real estate (although we are not able to verify this independently).

[1] https://www.ipf.org.uk/resourceLibrary/the-size---structure-of-the-uk-property-market-year-end-2020--january-2022--report.html (See Table 4.1. This report was published in January 2022)

In terms of property owned directly by SIs, we understand that a large proportion of this is offices, but that increasingly there is interest in data centres and logistics (leading to increased investment by SIs outside London (see response to question 32).

**Q12. Do you have any comments on how the government should approach existing qualifying investor status in relation to sovereign investors? In particular, are there any practical issues that could arise if this status were removed? If possible, please provide details of each area listed above in turn.**

The Consultation refers to a number of areas of UK tax where an SI is conferred with the status of being a "qualifying" investor. In each of these areas, the inclusion and status of SIs was a deliberate policy decision (and in some cases was with the objective of encouraging UK investment by SIs—this is particularly the case for QII SSE).

We note the distinction made by the government between where SIs are included as a qualifying investor because of their tax exemption and where they are included simply as an example of a large institutional investors with particular structures and profiles as opposed to capturing those with tax exempt status in respect of a particular stream of income. The inference is that in the latter case an SI would no longer be a qualifying investor. However, given that the effect of such a change would impact not only the SI, but could have material adverse tax consequences for other investors if it led to the underlying vehicle exiting the relevant regime, we agree that care is needed when considering any possible changes (and also, as referenced in our response to questions 7 and 8, is why we recommend grandfathering for existing structures for an appropriate transitional period).

Our comments below relate to three of those areas (being those most closely connected with investment in UK real estate (and UK property rich companies): the REIT regime in Part 12 CTA 2010, QII SSE in Sch 7AC TCGA and the fund exemption election in Sch 5AAA TCGA.

In relation to the QAHC regime, we agree with the government that SIs should continue to be "relevant qualifying investors" within para 10, Sch 2 FA 2022 (although the definition of a sovereign investor would need to be revisited as sovereign immunity would no longer be a determinative characteristic of status).

*REITs*
The list of "institutional investors" within s528(4A) CTA 2010 is relevant to each of the non-close and listing conditions. These conditions relate to ensuring a REIT is widely held and (in relation to listing) marketable and subject to certain disclosure requirements. Therefore status as an "institutional investor" - which determines if the relaxation of these conditions introduced in 2012 and 2022 respectively can apply - is because of the nature of that investor (implicitly widely held) rather than exemption from tax (with the reference to the SI's exemption in s528(4A)(h) CTA 2010 a matter of definition of a sovereign).

On that basis, we consider that SIs should remain "institutional investors" within s528(4A) CTA 2010 for the purpose of these two conditions (although, as for the QAHC regime, the definition of a sovereign investor would need to be revisited).

This should certainly be the case for existing REITs. If SIs were removed from the list of institutional investors, a REIT could face an involuntary exit from a regime which, in a number of cases, the FA 2012 changes were intended to allow them to access. (We understand that, following the 2012 changes, a number of "joint venture" REITs were created although we have no information as to the number of such REITs). As, in some cases, these would be between a SI and another institutional investor, loss of REIT status would be likely to have a material adverse effect on the position of that other investor (who may themselves be—and stay—exempt).

However, for the reason given above as to the rationale for s528(4A) CTA 2010, we consider that SIs should in any event continue to be an institutional investor for new REITs, as well as existing REITs

If there is a policy intention to differentiate between SIs generally and sovereign pension funds, we suggest that s528(4A) CTA 2010 reflect that distinction (so foreign public pension funds become a separate category of institutional investor (see response to question 28).

We recognise however that exemption (rather than institutional status) is relevant to the structure of the REIT regime (in that investors, not the REIT itself, are liable to tax on property business income and gains)—but consider that this is a matter for dealing with through the taxation of returns from the REIT, rather than eligibility to be a REIT).

Here, SIs are not currently entitled to receive gross payment of PIDs but instead have to reclaim any tax withheld. Should SIs become taxable, then whether or not they can reclaim any tax withheld will become dependent on the availability of treaty relief (see response to question 30 below) in relation to which the holders of excessive rights provisions would be relevant.

Therefore, assuming sovereign immunity is removed, (exempt) income and gains distributed to SIs by the REIT would be taxed in the hands of the SI.). No changes would be needed.

Although a REIT is required to distribute a minimum of 90% of exempt property business, the regime specifically allows for retention of capital gains for reinvestment (and hence s547 CTA 2010). We understand that the government has concerns that an SI could, by investing indirectly via a "captive" REIT, obtain a tax advantage (by deferring tax on gains for an indefinite period) and thus undermine the proposed reforms.  We consider that this is an area where, if changes are to be made, particular care is needed to ensure that the change is targeted and proportionate, noting that under the existing REIT rules, HMRC has under s545 CTA 2010 the ability to cancel certain tax advantages (and ultimately give notice to terminate REIT status under s572 CTA 2010). We would be happy to discuss the treatment of capital gains in a REIT further in the context of "captive" REITs as the government's thinking evolves, but as a general comment consider that, in other cases, the normal REIT rules should apply - so a SI is treated no differently to any other taxable investor.

In particular (a) a change to the REIT regime itself concerning the treatment of capital gains could adversely impact the ability to reinvest in "new" property rental business assets; (b) an approach that involved imposing a tax charge on an investor who has not itself received the income/gain to which that charge relates should, as a matter of general tax policy, be avoided (and in any event the need to provide a credit mechanism for tax paid when an amount representing the relevant income/gain is distributed would add significant complexity—here, although we note that Sch 5AAA TCGA provides for possible "dry" tax charges, these are in very limited cases and so would not necessarily be an appropriate precedent for REITs where disposals are commonplace) and (c) SIs, like other investors, look to employ their capital productively and so, as a commercial matter, sale proceeds would be expected to be reinvested in the REIT's business over the short to medium term and if not, returned for use by the SI for other (productive) purposes.

Finally, the Consultation suggests that SIs would be liable to corporation tax on PIDs—referencing existing corporation tax rules. However, given the territorial scope of corporation tax, a PID received by a non-resident would generally be liable to income tax (as discussed with HMRC in relation to Sch 5 FA 2019, the property income "fiction" does not extend to deeming a property business to be carried on in the UK: s5(2)(c) CTA 2009 and s548(5)(6) CTA 2010). Please clarify if a specific corporation tax charge would apply to SIs on receipt of PIDS: this may have benefits in terms of simplicity ( compliance-wise, it would be preferable for the SI to have to file one (corporation) tax return). .

*QII SSE*

Status as a "qualifying institutional investor" (QII) with the SSE rules is predicated on exemption from UK tax (para 30A Sch 7AC TCGA). The rules in effect pass the benefit of the QII's exemption to a company in which it invests. The QII SSE rules were introduced in 2017 to encourage institutional investors to establish investment platforms in the UK.

The removal of exemption from SIs therefore would suggest that changes need to be made to QII SSE, but we do not consider it would be proportionate to simply remove SIs from the list of QIIs for the following reasons:

(a) first, given the territorial limits of UK tax, a (taxable) SI would nevertheless be outside the scope of UK tax on a disposal of shares in a company other than a UK property rich company and so retains a (de facto) exemption;
(b) secondly, where there are multiple QIIs investing in a particular structure, the status of a SI can impact the extent of relief available (noting the two cliff-edges within the rules of 80% and 25%).

For existing structures set up as a result of the 2017 changes, removing SIs from the list of QIIs could cause significant disruption (particularly where an existing structure assumed full exemption, but, absent the SI as a QII, only partial exemption is available); and

(c) thirdly, issues around transition - as the disposal that attracts QII SSE is by a company owned (directly or indirectly) by QIIs (not the QIIs themselves) the rebasing proposals set out in the Consultation would not apply, so where (any) exemption is lost, tax would apply to gains that had accrued (but were not realised) at commencement (for the SI and also potentially other investors). Legislating for a form of "inside" rebasing would be possible, but complex: although one approach could be that each relevant entity makes a deemed disposal on commencement (determining the amount of (latent) gain/loss at that time) with that then determining base cost on an actual disposal by the entity, there could be complications if there are changes in level of investor interest between deemed and actual disposal.

In addition, we therefore recommend that any changes to QII SSE in connection with the proposal are targeted so that status as a QII is maintained where the underlying disposal, if made by the SI, would not be subject to UK tax. If the taxation of property gains is ultimately the policy outcome of the consultation, this would suggest an exclusion from QII SSE for indirect disposals of UK land only, with consideration given to the interaction of the QIII SSE rules with both the REIT and CGT-exempt fund regimes. (In addition, depending on the policy approach taken to SIs, it may be that some indirect disposals of UK land should continue to benefit from QII SSE—for example, if an SI retains exemption on returns from a UK REIT/property fund, then there is an argument that QII SSE should continue to apply to disposals made within that structure.

In this context, as discussed in the QAHC consultation, where a platform invests in real estate across a number of jurisdictions, a company may move between UK-property richness and non-UK property richness (under the QAHC regime, this change results in a market value disposal and (if from non-UK property richness, a tax charge). For SIs investing in QAHCs, QII SSE is a means of managing that tax risk. We therefore ask that consideration be given to this issue in relation to the interaction of the QAHC regime and any amendments to QII SSE (and in particular we would be happy to discuss this issue, in relation to the QAHC regime itself, with your colleagues in the UK Funds Review team).

In addition, we ask that consideration is given to a means of rebasing so that pre-commencement gains are not brought into charge where, had the disposal been made prior to commencement, QII SSE would apply. We acknowledge that legislating for this is unlikely to be straightforward (noting that (i) QII SSE was "bolted on" to SSE but policy wise has a different objective and (ii) its interaction with the REIT rules) and so would be happy to discuss further as government thinking evolves. However we consider that this is needed: QII SSE was introduced to encourage use of the UK for investment platforms, and we are concerned that proposing a change that could adversely affects investors who have now come to the UK within 5 years of its introduction runs the risk of undermining the original policy aims of QII SSE (and at a time when the UK is looking to build on

QII SSE with the QAHC regime): for investors, certainty and stability are important elements in their investment decisions—see response to question 34.

For existing structures, grandfathering for an appropriate period would alleviate some of the issues referenced above (particularly (b) and (c)): however, taking account of (a)—and because any grandfathering would be time-limited—an approach is needed that works for existing and new structures (with existing structures nevertheless able to have a window in which to consider options in response to the change).

*Fund exemption election*
The fund exemption election in Sch 5AAA TCGA is intended to ensure that, where a qualifying fund invests directly or indirectly in UK real estate, tax on disposals is effectively paid by investors, and not within the fund. Therefore the fund (and its AHCs) is exempt, and para 21, Sch 5AAA is intended to ensure that gains are returned to investors in a taxable form (and not be ordinary dividend).

We consider that the position for SIs as "qualifying investors" for the purposes of the non-close condition in para 13 Sch 5AAA TCGA is the same as for REITs, and so its inclusion is because it is an institutional investor rather than because it is exempt. We therefore consider that, for funds that have already made the election and new funds, SIs should still be qualifying investors for this purpose. For funds that have already made the election, this means that they can remain in the regime—and thereby avoid other (taxable) investors having a deemed disposal under para 22 Sch 5AAA TCGA (and the resultant dry tax charges) and (exempt) investors being treated differently to how they would have been treated had they invested directly. An involuntary exit (and resultant deemed disposal)—and the commercial and cost implications of that for fund and investors - as a result of a change in government policy would risk undermining the policy aims of this regime.

However within Sch 5AAA TCGA are provisions directed at particular investors, conferring exemption on any intermediate vehicle through which it holds its interest in a fund (paragraph 33 Sch 5AAA). For these purposes, the exempt status of the investor is relevant (as para 33 applies the definition of QII from Sch 7AC) and so we appreciate that, depending on any changes to QII SSE, this may need to be amended (to exclude SIs)s if the proposal is taken forward. For existing companies that benefit from this provision, we refer to our response to questions 8 and 9 concerning transition.

In this context, a "qualifying investor" is also relevant to the definitions of collective investment vehicle in paragraphs 1(e) and (f) Sch 5AAA and so the interaction of these definitions with other provisions of Sch 5AAA would need to be considered if continued status as an SI applies for these definitions (we have not considered this any further at this stage but as discussed previously, the position may be balanced given that the meaning of collective investment vehicle determines the extent of the interest a non-resident must have to be liable to tax on indirect disposals (whether 25% under Sch 1A, any % under para 6, Sch 5AAA or 10% under para 7B, Sch 5AAA) and the ability to make an exemption election—and the approach here will ultimately be influenced by the other changes needed to implement the final policy decision.

**Q13. Are there other areas of tax law where the proposed changes to sovereign immunity may have knock-on impacts?**

No comments: it may be that, assuming the proposal is taken forward, such areas are identified as the detail of the measure becomes clearer.

**Q14. Do you have any comments on the proposed approach to Inheritance Tax?**

No comments.

**Q15. Do you have any comments on the proposed approach to international organisations?**

No comments, other than to note that maintaining these exemptions (for understandable reasons given the legal obligations to which the UK is subject) is not necessarily in keeping with the stated policy objective of ensuring a level playing field (particularly as the members of such organisations will no longer have sovereign immunity if these proposals are taken forward).

**Q16. Do you agree that immunity from liability to direct tax should be removed from the Crown overseas and only the same immunities granted as those available to foreign sovereigns?**

No comments, other than to note that given the stated policy objective of the proposal is to ensure a "level playing field" such a change would be in keeping with that objective. However this is ultimately about the relationship between the UK and its overseas dependencies (rather than tax per se) and so we do not have a particular view.

**Q17. Do you have any comments in relation to the proposed approach to repealing the dominion governments provision as set out in s25 of Finance Act 1925?**

No comments.

## Chapter 5: Administration

### Q18. Do you have any comments on the proposed application process?

We have no specific comments on the nature of the application process as such, but agree that for SIs that are non-natural persons, the application process should be a one-off process (with the SI responsible for notifying changes)—we have no view on the position for individual heads of state where we recognise that other considerations may apply (particularly where they are elected).

We recommend that the process is made as user-friendly and straightforward as possible. This is particularly important given that the Consultation implies that SIs whose status is established and known to HMRC will need to re-apply. As was the case for non-residents moving to corporation tax, HMRC should commit to communicating directly with SIs in advance to advise them of what is required (or alternatively given that we understand that the DTI is likely to have a relationship with key SWFs2, works with the DTI/the Office of Investment on a communication strategy) and considers, where it has relevant information already, pre-populating forms. We also suggest that SIs are able to apply for confirmed SI status at least 6 months before the commencement date—and that in any event HMRC commits to providing confirmation (and a UTR) within a reasonable (and appropriate) timescale (with sufficient resources committed to ensure that this commitment is met in practice).

In addition, consideration should be given as to how to streamline the application process where an SI, whose immunity has been confirmed, sets up a new company to hold specific investments (assuming such company is itself able to benefit from SI exemption from withholding as per question 3).

Finally, HMRC should clarify in its communications how a confirmation as to SI status interacts with other processes/applications are status-linked (e.g, treaty claims and NRL Scheme authorisations)—with systems minimising unnecessary duplication (or other "reinventing of the wheel").

### Q19. Should applicants be required to provide information about all their investments and any changes to these?

No. We consider that the reporting obligations imposed on SIs should be no different to those applicable to other non-resident taxpayers and so the only information that needs to be reported would be that required to be included in a tax return. That would provide information about some changes (e.g. material changes in income could suggest a new investment has been acquired and disposals would be reported on in any event).

[2] See DTI written evidence to the International Trade Committee's 2021 inquiry into Inward FDI.

Further consideration should be given to the accounting information required to be given in support of a tax return to ensure that an SI that owns assets directly does not have to file information about activities outside the UK (noting that this too was an issue considered in connection with non-resident company landlords moving to corporation tax).

**Q20. Should only the top entity that is immune be required to register for sovereign immunity if that entity is the beneficial owner of income that flows through a number of subsidiary entities?**

Generally, see response to questions 3 and 18 concerning companies owned by the SI. Given the "corporate veil" and the nature of the legal analysis relevant to determining whether an corporate-like entity is opaque or look-through for tax, we can see benefit in requiring confirmation as to SI status for each entity through a simplified process that piggy-backs off the SI's own status, rather than HMRC having to agree the classification of that entity (or indeed, given immunity is limited to interest, apply Indofood principles to establish beneficial ownership where a treaty claim is made).

**Q21. Do you have any comments about reporting?**

We recommend that each SI are allocated a Customer Compliance Manager (CCM) whether or not they would otherwise qualify. Given the importance of investment by SIs in the UK, it is critical that they receive a high level of service from HMRC (and that HMRC are responsive to requests for support and assistance, particularly in relation to commencement and the first few accounting periods).

We would also recommend that an SI's CCM be involved in any application by that SI for treaty relief and/or the new withholding tax exemption, as a means of ensuring such applications are processed without undue delay (for similar reasons).

See also response to question 8 on transitional matters.

**Q22. Do you have any comments on the proposal to require sovereign persons to follow the existing self-assessment processes under Income Tax, Capital Gains Tax and Corporation Tax? Are there any practical difficulties with this?**

We consider that, where an SI applies for confirmation of immunity, that application should also cover registration for corporation tax in relation to applications pre-commencement.

For new SI investment, the application could perhaps helpfully include an option to apply for registration for corporation tax within it (if it is not already registered). Although we recognise that these processes are likely to be managed by different teams in HMRC, a "one-stop" process with HMRC dealing with constituent parts internally would be appropriate.

**Q23. Do you have any comments about tax payments?**

We consider that quarterly instalment payments should not apply to SIs for at least the first accounting period after commencement: see response to question 8.

**Q24. Do you have any comments about how to ensure compliance with the new rules?**

See response to question 21 above concerning the need for SIs to be supported by a CCM.

In addition, as above, we understand that the DTI seeks to build relationships with key SWFs and so consideration could be given to using DTI's links as a means by which information is provided to SIs (with HMT/HMRC providing specific contacts for DTI/the Office of Investment) to help SIs operate effectively in the UK.

**Q25. Do you have any comments about the removal of jurisdictional immunity in respect of liability to direct tax?**

No comments, other than to repeat our recommendation for SIs to have a CCM whose management of the relationship with an SI in the event of a potential dispute may assist in minimising the risk of direct SI involved in proceedings before a tax tribunal.

## Chapter 6: Impacts

**Q26. Do you have any comments on this analysis, particularly on the extent to which SWFs and foreign public pension funds income is currently sheltered by sovereign immunity or Crown immunity, and the extent to which the proposed new rules will increase their overall tax liability?**

As there is no general public data available around SI investment in UK real estate, we cannot comment on the analysis carried out by the government. Assuming that the change does not have a behavioural impact, SIs that invest in UK real estate should have an increased liability to tax save to the extent exemption is available under a tax treaty (i.e. where investment is indirect only). We assume that modelling by the government of impacts will take account of likely behavioural impact in light of stakeholder feedback.

**Q27. What are the most common ownership structures used for SWF and foreign pension fund investments in UK property?**

In relation to UK real estate, there are a number of different investment structures used by institutional investors generally (including SIs), some of which result from specific policy decisions of the government to attract inward investment in to UK real estate.

First, an SI may hold a property directly.

Secondly, an SI may enter into a joint venture arrangement with a small number of other investors, potentially just one other. That joint venture could be by way of partnership or JPUT (Jersey property unit trust) as such vehicles would allow the SI to engage its immunity on investment returns (noting that since 6 April 2019, investors in a JPUT have been able to make transparency elections for CGT under Schedule 5AAA TCGA (see CG73997S "HMRC would anticipate the likely users of this election to be smaller, joint-venture arrangements where the investors are predominantly or wholly exempt and/or are unlikely to change regularly.").

Thirdly, an SI may invest in a (listed) REIT, acquiring a minority holding (simply by acquiring shares on the stock market like any other investor).

Fourthly, an SI may take a material stake in a REIT (i.e. a holding > 10%). In such a situation it is likely that the REIT would be a closely held institutionally owned REIT, with the SI being one of the qualifying institutional investors. The SI could have a controlling stake or the REIT may be a deadlocked joint venture arrangement.

Fifthly, the SI could set up a captive REIT (i.e. a REIT that is wholly (or almost wholly) owned by that SI).

Sixthly, in some cases the SI may invest in an opaque corporate structure for legal, or commercial reasons (in particular where this is a joint venture structure and the SI is a minority investor), and therefore the SI would benefit from exemption on income profits within that structure but gains on share sales within the structure may benefit proportionately from QII SSE (or the 'normal' trading SSE in the case of underlying operational trading businesses).

Seventhly, the SI may invest in a property fund. Such would generally be set up as a limited partnership with individual investment properties held by either asset holding companies or JPUTs. For such funds, since 1 April 2019, an exemption election would be available (ensuring exemption from CGT at fund level) such that the SI can effectively engage its exemption on capital gains.

We note that many of the structures in which an SI may invest in UK real estate are tax-transparent (or, in the case of a REIT, effectively tax transparent) for income (and in some cases capital gains) as a result of which the SI is able to engage its exemption from tax. As a matter of practice therefore sovereign immunity will have influenced its choice of investment vehicle. Should the proposal set out in the Consultation be taken forward, tax-transparent structures may be less attractive, particularly given the reporting obligations imposed on the SI if it is the beneficial owner of rental income. At this stage of the policy process however it is not possible to comment on how SIs would structure their investments in UK real estate if the proposal is implemented—though we note that (taxable) investors in real estate generally prefer tax-opaque vehicles (companies) to own their investments given the commercial and legal benefits (such as those discussed in the summary of responses to the first stage consultation on AHC.)

**Q28. Are you aware of the extent to which foreign sovereign and Crown immune public pension funds are able to register for UK tax purposes or are eligible as overseas pension schemes, or of any other alternatives to sovereign immunity which SWFs and public pension funds would look to should the proposed changes to sovereign immunity go ahead?**

**Q29. Are there any unintended consequences of these changes on foreign public pension funds?**

First, as set out in response to question 2, it is unclear whether, in relation to SI pension funds, the “level playing field” in policy terms is intended to be with UK pension funds or non-UK investors/SIs generally. If the former, this is not achieved by the proposal as it is clear in the Consultation that not all SI pension funds are expected to be eligible for any of the listed exemptions.

In any event, the options referenced in the Consultation (registering for tax purposes or qualifying as an “overseas pension fund”), even if available, are not comparable with the exemption that such government pension schemes currently have through sovereign immunity.

In particular, assuming a government pension scheme is eligible for overseas pension scheme (OPS) status, it will be able to access exemption from UK tax on gains only (and not on income). In any event, we understand from our members that, given that to access OPS, the non-UK pension scheme has to meet a definition based on the UK pension fund model, it is often difficult for the non-UK pension scheme to qualify—for example, where a government pension scheme provides benefits to all a state’s residents, because of the lack of an independent regulator and/or because contributions are not ringfenced (e.g. similar to the UK state pension).

This is particularly an issue where the investment activity and the administration of the pension scheme are carried on by different legal entities (so that the person carrying on the investment activity may not fall within the exemptions available).

If a non-UK pension fund registers for tax purposes as a pension scheme (an RPS), then this should allow it to obtain exemption from UK tax on both income and gains (and so is more comparable to sovereign immunity). We understand from our members however that in practice there have only been a limited number of applications for RPS status by non-UK pension schemes. This is because a RPS is subject to regulation by the UK Pensions Regulator over its entire worldwide assets (in addition to regulation in its home jurisdiction). As a result, and noting UK investments will generally represent only a small proportion of the scheme's total assets, the costs of UK regulation tend to outweigh the potential benefits of UK tax exemption. For an overseas government pension scheme, there is a policy question in any event as to whether it is appropriate to require it to be overseen by a UK regulator.

As a result we do not agree that the existing rules for overseas pension schemes offer a means by which SI pension funds can be legally exempt from direct taxation on their other forms of income in a way that is equivalent to their current exempt status. It may be that, in some cases, an SI pension fund is entitled to exemption on (some income) under an applicable tax treaty (see response to question 30), but this is very much dependent on the specific terms of that treaty (and again does not compare with immunity).

If the government's policy objective is to allow non-UK SI pension funds to benefit from exemption on investment income and gains, then we recommend that either (a) the government carry out a review of the existing non-UK pension fund regimes with a view to making them more accessible than at present or (b) introduce a new SI pension fund definition/exemption specifically for the purposes of this proposal. Given the government's timetable for this proposal, although option (a) is in our view preferable (as a level playing field should take account of the position of private pension schemes too), we consider that only option (b) is likely to be feasible.

**Q30. Are there any other legitimate mechanisms through which sovereign persons could continue to benefit from tax exemptions?**

Under the proposal, we note that the government considers that some SIs may be able to maintain immunity as they are constituted as a pension fund (and so, we assume, it is intended that they should benefit from an equivalent exemption as that available to UK pension funds).

For other SIs, exemption (or relief) from tax may be available in relation to PIDs paid by REITs and interest payments under the terms of an applicable tax treaty. For example, referencing the jurisdictions in which the SIs with the highest levels of UK investment are based:

- the UK/Canada treaty: Article 10(3) limits withholding tax on dividends to 10% where the recipient is a specified type of pension fund (and that fund holds no more than a 10% interest in the dividend payer)—otherwise the rate is 15%;

- the UK/China treaty: Art 10(3) confers exemption from withholding tax on dividends where the recipient is a government institution or a company wholly-owned by the government (with Article (10)(2)(b) limits UK withholding tax on dividends paid to other Chinese residents by certain investment vehicles (which should include a REIT) out of income derived from UK real estate income and gains to 15% and Article 11(3) exempts government institutions from withholding tax on interest;
- the UK/Kuwait treaty: Article 10(2) exempts dividends paid by certain investment vehicles (which should include a REIT) out of income derived from UK real estate income and gains to 15% unless the recipient is a pension fund (in which case an exemption from withholding applies) and Article 11 exempts SIs and pension schemes from withholding tax on interest;
- the UK/Norway treaty: Article 10(3) exempts Norwegian government entities from withholding tax on dividends;
- the UK/Qatar treaty: Article 10(2) exempts dividends paid by certain investment vehicles (which should include a REIT) out of income derived from UK real estate income and gains to 15% unless the recipient is a pension fund (in which case an exemption from withholding applies) and Article 11 exempts SIs and pension schemes from withholding tax on interest;
- the UK/Singapore treaty: Article (10)(2)(b) limits withholding tax on dividends paid a REIT to 15% and Article 11(3) and (4) exempt certain Singapore SIs from withholding tax on interest; and
- the UK/UAE treaty: Article (10)(2)(b) limits withholding tax on dividends paid to a UAE pension fund by certain investment vehicles (which should include a REIT) out of income derived from UK real estate income and gains to 15% and Art 11(3)(a)(i) and (iv) and 11(4) exempts Sis and pension funds from withholding tax on interest.

**Q31. Would sovereign investors be likely to reduce their overall investment into the UK as a result of the proposals? If so, to what extent?**

As a general matter, we understand and assume that the government will have been discussing this proposal directly with SIs who are the best placed to answer this question.

In general, we would anticipate that the investment strategy of SIs will involve allocating funds between different geographic regions and asset classes. Whether the proposal (in essence, given the availability in many cases of exemption from withholding tax on interest, under UK domestic law or an applicable treaty, the removal of sovereign immunity) would affect allocation of funds to UK real estate-based investment will however depend on their individual risk/return appetite—and of course the availability of alternatives (whether in the UK or elsewhere). The impact of tax on returns from particular assets/jurisdictions would be a factor to be taken into account, but other factors would also be relevant to decisions.

We note here the written evidence of Diego López, Managing Director at Global SWF to the International Trade Committee's inquiry into Inward FDI in 2021 which included a SWOT analysis of the UK as an investment destination which highlighted a number of factors that he saw as relevant to allocation decisions. These included yields (he commented that a "weakness" was that the UK had lower yields than emerging markets). The incidence of tax over an investment's life reduces yields further, but as investment decisions are relative, and not just absolute, it is not possible to comment on the likely effect with certainty. But we note that, in an interview with Laura Kuenssberg on 3 September 2022, the Prime Minister acknowledged the role that tax rates play in investment decisions, expressing the view (in the context of the 6% increase in rates legislated to come in on 1 April 2023) that "if we raise corporation to the same level as France … it will be harder for us to get the investment and harder to get the jobs and growth" and "putting up tax on business is not going to attract more businesses to invest in this country".

The government response to the International Trade Committee's report described SIs as a "priority investment group" given their role "as an important source of long-term patient capital for the UK." The government said that:

> "Attracting and enabling sovereign investors to operate effectively in the UK is vital to job creation and the UK's growth as a world leader in life sciences, clean growth, technology and innovation."

Lord Grimstone, the then Minister for Investment, in giving evidence to the International Trade Committee's inquiry in 2021, said that "attracting inward investment has become "a globally competitive sport [ … ] where you have to be match fit" (see paragraph 56 of his oral evidence). UK real estate has historically been an important asset class for SIs. Therefore, even though their direct holdings may be seen by the government as "relatively small proportion of the total UK property market", they may nevertheless represent a significant proportion of an individual SI's total UK investments—Mr López told the International Trade Committee that "sovereign funds have traditionally liked British properties and infrastructure, and that has been the focus traditionally". In our view, a significant change to how SIs are taxed on their UK investments must run the risk of reducing the UK's "match fitness" as compared to other jurisdictions who are competing for SI funds, impacting the ability to attract new investment.

This is not to say that a change to the UK taxation of SIs should not be made, but that a full assessment of the impact (which we note is yet to be carried out) needs to be based on robust data and reasonable assumptions. Further, in our view, the need for "match fitness" strengthens the case for appropriate grandfathering as part of transition, so that the government makes clear to SIs that it recognises of the significance (and indeed unexpectedness) of the change and provides for those SIs already invested in the UK a period in which to adjust/restructure existing arrangements (mitigating the cost to the SIs of the change across its overall (old and new) UK investment portfolio)— a sort of "phasing in" to a new fully taxable world. SIs are generally seen as long term investors, and returns for existing structures will have been modelled on the basis of exemption—removal of immunity means those models need to be revisited. If and to the extent any SI felt that the proposal represented a “moving of the goalposts” such an approach would indicate that the government is attuned (and responsive) to such sentiments, whilst nevertheless (for the reasons it advances in the Consultation) making the changes it considers necessary.

See further responses to questions 32 and 35 and, on transition, questions 8 and 9.

**Q32. Are there particular asset classes which would be particularly affected by the changes, and if so, how would this affect sovereign entities’ allocations of these assets within their portfolios?**

As the Consultation itself acknowledges, the main impact of the proposal is on investment by SIs into UK real estate—whether direct or indirect (through a REIT or tax-transparent property fund). We would therefore expect that SIs would re-assess their investment approach to UK real estate. As above, whether this would affect allocation of funds to UK real estate-based investment will however depend on an SI’s individual risk/return appetite—and of course the availability of alternatives (whether in the UK or elsewhere). Given that investment portfolios would allocate funds by reference to asset class as well as geography, it is possible that funds earmarked for UK real estate could then be re-allocated to other jurisdictions: see response to question 35.

We understand and assume that the government will have been discussing this proposal directly with SIs who are the best placed to answer this question.

We note also that UK real estate can itself be sub-divided into particular asset classes. The written evidence of Diego López, Managing Director at Global SWF to the International Trade Committee’s inquiry into Inward FDI, showed that, in recent years, the nature of SI investment in UK real estate has changed. His evidence includes a graph (“What is happening with Real Estate?”) showing that SIs are increasing investment in data centres and logistics. On logistics, Mr López’ evidence included a graph showing that, in the first six months of 2021, 65% of SI investment in UK real estate was in logistics compared to 15% on offices (and, in 2020, 60% for logistics and nothing for offices). This change in strategy is likely to have increased regional diversity of SI investments (as noted by Mr López).

Therefore to the extent that the proposal did lead to reduced UK real estate activity by SIs, our concern is that this would lead to a reduction in these particular classes of real estate—with the potential for impact on those areas of the UK that are the focus of the UK’s levelling up agenda unless other funding for such development can be found.

Mr López also referenced SI interest in student and senior housing, and we have heard anecdotally that SIs are also now investing in social housing (and we reference above investment in developing BTR by a joint venture involving ADIA).

Again, this is not to say that a change to the UK taxation of SIs should not be made, but that the full assessment of the impact (which we note is yet to be carried out) needs to be based on robust data and reasonable assumptions.

**Q33. What is the scale of investment in UK property by foreign sovereign individuals? Is such property likely to be rented out with a view to generating rental income, or held for purely private occupation purposes?**

No comments.

**Q34. Do you have any comments on the government's expectations regarding economic impacts, including any potential impacts not reflected?**

First, see our response to questions 31 and 32.

*Investment aligning with government priorities*
Both the report of the International Trade Committee into FDI and the response of the government emphasise the valuable role played by SIs as an investor in the UK. The evidence given by Lord Grimstone, then Minister for Investment, indicated some of the steps taken by government to attract and retain such investment. The government response said it was looking "to partner with sovereign investors seeking high-value investment opportunities in the UK which align with key government priorities, such as net zero, levelling up, infrastructure, and research and innovation".

We highlight above the change in the nature of real estate investment by SIs, increasing SI's exposure to the regions through investment in logistics (adding to local economic activity)—investment that supports regional economies.

In addition, the built environment has a vital role in enabling the UK to meet its commitment to carbon net zero by 2050 as currently it is responsible for a significant proportion of all greenhouse gas emissions in the UK. As a result, there is a need for significant investment, including in new types of building/building techniques and new technologies - as well as learning how to use new technologies to retro-fit and improve the energy efficiency of existing buildings—and we consider that SIs are well-placed to contribute to this (given the nature of their investment and focus on the longer term).

SI investment is mobile, and many countries compete for that investment. As a result, it is important that, if the proposal is taken forward, it is done so in a manner which ensures that the UK remains competitive, and that SIs continue their investment in the UK (in real estate and other assets). The proposal is to go to "all" from "nothing" in terms of tax—which, taking into account our comments on the approach taken by other countries, may result in the UK having a less generous regime for SIs than in other comparable investee jurisdictions. We therefore ask the government to consider some middle ground (for example, as in the US in relation to REITs and in Australia in relation to grandfathering).

*Means of attracting investment*
In his evidence to the International Trade Committee, Lord Grimstone said that "financial incentives can be vital to securing investment in a competitive environment" and the government was "considering various ways we can offer incentives to investors".

Whereas a financial incentive is intended to reduce costs on a particular investment, this tax change will (for certain investments) increase a SI's costs. We recommend that HM Treasury liaises with the Office of Investments to consider whether this proposal could ultimately lead to an increase in financial incentives (whether to offset some of the tax cost and thereby allow an SI to maintain yield or (if relevant) to counter any negative investor sentiment that may result from the proposal)—and if so for that to be taken into account in modelling any assessment of its impacts (and overall Exchequer consequences).

*Stability/Certainty*
The Consultation references the UK's stable regulatory framework as an advantage. Our understanding from members is that stability (and as a result predictability as to the impact of tax on returns) is something that investors look for in relation to a tax system.

Whilst we acknowledge the need to keep the tax system under review, and make changes from time to time (including by reference to international developments such as BEPS, there is a sense among our members that, particularly in recent years, there have been a number of "out of the blue" material changes to long-standing tax rules announced as "decided" with consultation on detail only. Many of these impact real estate investment, of which this proposal is most recent. Each of these has its own policy rationale and can be understood on its own terms—but the cumulative effect of these (major and yet nevertheless incremental) changes is to create uncertainty. For example, over a period of 10 years, the UK has moved from a long-held position of not taxing non-residents on gains on UK real estate to taxing (or consulting on taxing) everyone (other than UK and (perhaps) some SI pension funds) on such gains. In terms of timing, these changes came into effect in 2013 and 2015 (residential property/certain taxpayers), 2019 (all property/all taxpayers), 2020 (corporation tax/CIR and not income tax) and now (prospectively) 2024). All of these were consulted on (and in relation to the 2019 changes, the responsiveness of Government to concerns resulted in Sch 5AAA TCGA) but even so the perception of constant change remains. Uncertainty as to whether the tax position in 5 years will be the same as now impacts investor sentiment.

Further, there is a concern as to mixed messaging in connection with these recent changes. For example, in 2017, QII SSE was introduced to attract institutional investors (including SIs) to set up investment platforms in the UK—which we understand some have done. This was intentionally enacted to provide QIIs (including SIs) with exemption on (indirect) disposals of investment companies, including property companies—and as a result mitigated the impact of NRCGT for such investors. The QAHC rules are also intended to strengthen the UK's attractiveness as a platform location for such investors. The Consultation, referencing removing SI exemption (and potentially SI QII SSE), is published five years after QII SSE and three months after the QAHC rules came into effect. Similarly, as of April this year a REIT owned by at least 70% SIs no longer has to list, but the Consultation (three months later) suggests that such a REIT may no longer be eligible for the regime (because SIs may no longer be seen as "good investors").

We recognise that the government is consulting on these (and other issues) and in that consultation is being transparent about the competing policy objectives and has said it is conscious of the need to factor in to its thinking the impact on existing structures (and a consultation before conclusion is preferable to the alternative) but this adds to the uncertainty as to UK tax policy in this area.

In the short term, this uncertainty could have an impact on investment decisions being made now—for example, would it be sensible for a UK pension fund to enter into a new REIT JV with a SI currently, given the risk that in less than two years that JV may no longer be a REIT? This may simply be a deferral in investment and so a matter of timing, but could equally mean an investment opportunity foregone. Again, we understand and assume the government is discussing the proposals with SIs who are best placed to comment on the impact on their investment activity at this time.

We therefore want to emphasise the importance of communication and (to the extent the policy process allows, transparency) particularly with SIs, as the consultation process continues—and more generally the need for the government to take a more holistic approach to tax on real estate investment in the UK.

**Q35. With regard to property, how do you expect the proposal to impact the value of the types of properties commonly owned by sovereigns, and the rental yield required to make property investments viable when accounting for the change in tax liability?**

It is not possible to provide a simple answer to this question given that assessments as to level of rental yield required for an investment to be viable are influenced by a number of factors, including interest rate expectations, other macro-economic factors, and given that such investors are international in outlook, comparative (after-tax) yields available in other jurisdictions.

By way of an example, we set out below a (high level) comparison of returns from a hypothetical (indirect) investment in a French “core” real estate asset and a UK “core” asset. The same modelling inputs regarding acquisition price of the asset, hold period, income generated from the asset, debt and interest rates and operating costs have been used. In France, it is assumed that the asset is held through an OPCI (which would be expected for an asset of the assumed scale) and in the UK, in a REIT.

The modelling produces the following after-tax returns:

French asset - 6.48%
UK asset (current law, SI exempt) - 7.54%
UK asset (SI taxable, assumed 20% tax) - 6.24%

From this it can be seen that the difference in yields narrows significantly as a result of the change (with, on an assumed rate of 20%, the French asset producing a higher return). Obviously treaty relief may reduce the UK tax charge and therefore increase the post-tax return, but the above illustrates that, all other things being equal, the reduced return available to an SI after April 2024.

We note that what is acceptable as a minimum required yield will differ depending on the type of property and its location (the yield on a central London commercial office building differing from that on a logistics warehouse in Lancashire) and the above assumes a “core” property.

For directly held property, the imposition of tax on rents (at a level of 25% from 1 April 2023 under current law) similarly reduces the return available to an SI on an investment (and, although SIs tend to hold for the long term and so may not be as focussed on capital return over the medium term as other investors may be, the imposition of CGT on gains impacts the overall yield). In turn, simplistically, that will reduce the amount it is willing to pay for new property investments (given “value is a function of yield”)—although the extent to which it could impact valuations of existing properties held by that SI may depend on the basis on which that valuation is drawn up.

In this context, we note the HM Treasury research on the responsiveness of commercial real estate activity to changes in SDLT rates (at https://www.gov.uk/government/publications/responsiveness-of-commercial-transactions-to-stamp-duty-land-tax) which estimated that a 1% change in the effective tax rate (basically tax paid ÷ value of transaction) results in a 11.7% change in commercial transactions.

It may of course be possible for an SI to mitigate the impact of tax on rental income by restructuring how it holds its investments: for example, holding property through single purpose companies that are in part funded by debt but measures such as the corporate interest restriction limit the relief available (and restructuring existing investment structures would give rise to frictional costs (regardless of any tax-specific transitional relief that the government may legislate).

**Q36. Aside from property, are there other types of asset class commonly invested in by sovereigns which will be affected by the proposal in a way which might materially change the market for them?**

We assume "property" includes direct and indirect investment in UK real estate: on that basis we have no comments.

**Q37. Would other asset classes become relatively more attractive to sovereign investors as a result of the proposal?**

Institutional investors generally seek to create a diverse, balanced investment portfolio (i.e. the investor wants to avoid having too many eggs in one basket). Investors therefore allocate funds between asset classes and between jurisdictions by reference to their strategy and risk/return appetite.

We assume that the government will have been discussing this proposal with SIs who are  the best placed to answer this question. However we would note that it should not be assumed that an SI that has (in the past) invested in UK property would be attracted (and reallocate) funds to other UK investments: it may simply maintain allocation against real estate, but adjust the geographical allocation of such funds.

**Q38. Do you have any comments on the impacts on individuals, households, and families?**

No comments.

**Q39. Do you have any comments on these impacts, or any other impacts which have not been covered here?**

Please see our response to questions 18 to 24.