Tax treatment of asset holding companies in alternative fund structures

19 August 2020
To: UKfundsreview@HMTreasury.gov.uk

Introduction and background

The British Property Federation (BPF) represents the real estate sector – an industry which contributed more than £100bn to the economy in 2018 and supported more than 2 million jobs[1]. We promote the interests of those with a stake in the UK built environment, and our membership comprises a broad range of owners, managers and developers of real estate as well as those who support them. Their investments help drive the UK's economic success; provide essential infrastructure and create great places where people can live, work and relax.

Due to the bulky and illiquid nature of real estate investment, it naturally lends itself to collective investment – to allow investors to share risks and pool resources. Collective investment involves more complex ownership structures than a single owner investing in an asset directly, for a number of reasons - including the requirement to ensure that an investor can get a similar tax outcome on their returns as if they had made the investment directly. In recent years, there have been a number of tax changes in the UK which have jeopardised the ability of collective investment structures to achieve that tax neutral position for an investor – we therefore appreciate this opportunity to raise awareness of some of the barriers to using UK holding companies in collective investment structures.

We would highlight that it is important to look holistically at how well suited the UK is to support entire fund structures, of which the tax treatment of asset holding companies is one part – and to that end, we look forward to engaging further on the wider funds review in due course. In the meantime, we would be pleased to discuss our comments with you on this consultation in more detail. Please do not hesitate to get in touch if you require further information.

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Structure of this response:

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Appendix 2: Recommendations in respect of the REIT rules

Appendix 3: Recommendations in respect of the Substantial Shareholdings Exemption

Appendix 4: Challenges in respect of the Branch Profits Exemption

[1] https://www.bpf.org.uk/sites/default/files/resources/16688%20BPF%20Economic%20Footprint%20Report%2014.08.19.pdf

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Part 1: Executive summary and key recommendations

2. The UK's investment management industry is world leading – second only to the US, and bigger than the next three largest European hubs combined[2]. Given the strength of this sector in the UK, it is notable that the alternative investment fund industry is less strong in the UK – with many alternative fund structures, including real estate funds, electing to set up in other European jurisdictions – notably Luxembourg. We therefore welcome this consultation to better understand what the barriers are to alternative investment structures setting up in the UK – and in particular, how the tax treatment of asset holding companies influences this decision.

3. We share the government's ambition to seek to attract more alternative investment fund structures into the UK and agree that in doing so, this would support the creation of good quality jobs across the UK in the accountancy, legal and administration professions that support the fund industry. We estimate that the level of UK real estate currently held by overseas collective investment vehicles currently supports around 4,000 jobs – and contributes associated tax revenues from the annual accounting and administration services performed in the AHC jurisdiction. If the UK were to become an attractive location for AHC's to hold non-UK real estate, as well as UK real estate, the potential exchequer revenues and the number of jobs that could be supported in the UK, could be far higher.

4. It is important to look holistically at how well suited the UK is to support entire fund structures, of which the tax treatment of asset holding companies is but one part. The overarching aim in respect of the tax treatment of the whole investment structure, is to allow investors to achieve a similar tax outcome as if they had invested in the underlying asset directly – and therefore to limit any tax "leakage" on gains, dividends or interest payments that are repatriated through the structure. We draw out our key recommendations to address some of the challenges with the UK tax system below.

   A. **Withholding tax on interest**
   We would advocate for the removal of withholding tax on interest. Given various exemptions already exist, we would not anticipate a significant cost to the exchequer of this measure – and it would go a long way to improving the UK's relative attractiveness as a location for alternative fund structures. The current exemptions add complexity, which disadvantage the UK when comparing alternative holding company locations.

   B. **Substantial Shareholdings Exemption (SSE)**
   The SSE conditions present a significant competitive disadvantage when compared to other European jurisdictions' equivalent 'participation exemptions'. The UK could significantly improve the attractiveness of the SSE regime without damaging the integrity of the tax system by ensuring that any investment in a company holding non-UK property, whether it be trading or investing, would qualify for SSE.

   C. **The UK could be a hub for global REITS**
   We would like to see the UK REIT regime being able to attract pan European and global real estate investment structures. For this to be possible, it is critical that non-UK investors would not suffer UK tax on non-UK situs assets – and to that end, would reiterate our recommendations in respect of the SSE rules.

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[2] https://www.theia.org/sites/default/files/2019-09/IMS%20full%20report%202019.pdf

D. **Improvements to the existing tax rules vs a new regime**

While we would support the introduction of a new regime, we do have concerns that a new regime alone risks creating a cliff edge in tax treatment for some structures that may fall just outside the regime – and as such, a regime could distort otherwise commercial decisions in respect of how an investment should be structured. In addition, it may unintentionally advantage/disadvantage certain classes of investor when competing to acquire assets. Therefore, we believe that even with a new regime, it is important to address any unnecessary barriers and complexity within the existing tax rules.

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Part 2: Response to consultation questions

Question 1: What role do AHCs perform within alternative fund structures? What are the commercial and tax benefits of using AHCs within alternative fund structures, and what advantages do they offer versus direct investment?

2. We would agree with the benefits and functions outlined in paragraph 2.11 of the consultation document. The annotated fund structure diagram in appendix 1 explains what function the different levels of asset holding companies serve in an alternative investment structure. In summary, the typical functions served by master and asset holding companies are listed below.

   A. Consolidates capital/loan funding from the investors.

   B. Consolidates management agreements.

   C. Consolidates financial reporting and in many cases, the tax filing obligations – this is attractive for investors as it is much more efficient than each individual investor administering their own tax compliance.

   D. Consolidates corporate governance – using a shareholder/unit holder agreement to define the investment parameters etc. The board of directors of the AHC can then make decisions for the AHC and its subsidiaries in accordance with those agreements (to note this is more common functionality at the fund level, but in some cases plays a role at the AHC level).

   E. Security – a ring fence can be drawn around the AHC and its subsidiaries for security on bank lending if required. Furthermore, different lenders can lend to separate AHCs if they have different security rights over the same asset (e.g. to clearly distinguish between a senior and a mezzanine lender for example).

   F. Enables unsecured financing to be used e.g. bond listings require a certain portfolio size and, generally, asset diversification.

   G. Greater choice of exit strategy – it enables a portfolio exit at the AHC level rather than company by company or property by property.

   H. Facilitates the addition of new investors – particularly in a JV context.

   I. Keeps decision making in the structure and not at the fund vehicle level.

Question 2: To what extent are AHCs prevalent in other funds or pooled investment structures?

3. We would envisage that a number of the benefits of using AHC's above will be relevant for other investment classes – for example, infrastructure has a lot of the same characteristics as real estate and therefore we would expect it would also lend itself to a similar level of AHCs within a collective investment structure.

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Question 3: What do you consider to be the main fiscal and economic benefits to the UK – both direct and indirect - of greater AHC domicile? Can you support this with any quantitative evidence?

4. We would support the assertion set out Chapter 2 of the consultation that attracting AHCs to be located in the UK would support the creation of jobs in the accounting, legal and administration professions that typically service these structures – as well as the associated tax revenues generated within these sectors.

5. There are a number of different ways of estimating the potential expenditure that could be transferred to the UK if it was more attractive for UK real estate to be held by UK asset holding companies. However, it is incredibly difficult to estimate the number of funds which may transfer or choose to set up new funds in the UK.

6. Some of our members calculated how much they spend on their asset holding companies on annual services such as accounting and administrations services – it ranged from 0.05% of assets under management for very large funds to 0.1% of assets under management for small to medium sized funds.

7. If we take the estimated value of overseas investors in UK commercial real estate – this totals £156bn according to the IPF Size and Structure of the UK property market report 2018, plus an estimated 42bn USD (approximately £33bn) of UK property held via Jersey entities (according to Jersey Finance), which totals £189bn of overseas investors into UK commercial real estate.

8. If we multiply the £189bn by the range of percentages, this would indicate that between £95m to £189m is spent on servicing non-UK asset holding companies which own UK real estate (we assume the average of these figures, £142m, for our subsequent calculation on jobs). However, the potential pie for the UK exchequer would be much larger to the extent that the UK became an attractive AHC location for global real estate, in addition to UK real estate assets.

What jobs would this support?

9. It would largely support graduate or entry level roles within accounting and fund administration professions – professions which typically come with significant professional development and qualifications. If we assume the typical salaries in the early years of these professions are in the region of £35k per annum, the transition of UK real estate held by overseas investors to UK asset holding companies could support approximately **4,000 additional jobs** in the UK. It is worth noting that there are established hubs for the accounting and administrative professions across the UK - notably Exeter, Manchester, Leeds and Edinburgh, as well as London, so the job opportunities would be spread out across the UK.

10. To reiterate, this estimate is based on the UK becoming an attractive location to hold *UK* assets – the numbers could be significantly greater if the UK became an attractive hub to hold international, as well as UK, assets. Furthermore, this figure takes no account of other alternative asset classes, on which other respondents will be better placed to provide insight on.

Other benefits

11. Investment managers would be able to use UK based investment advisors and directors – if they are already in house, this would save costs and boost investor returns. We would also expect a cost saving simply by virtue of operating in fewer jurisdictions (e.g. lower risk exposure and consequently saving on the mitigation).

12. Climate change benefit – there would be no need for directors to travel on a plane for board meetings (this would also be particularly helpful in the current Covid environment where travel is restricted).

Question 4: For each of the fund classes identified in Chapter 3, what are the different challenges that the UK tax rules create for the establishment of AHCs in the UK? Are there any other fund classes for which similar challenges arise?

13. As noted earlier, the overriding objective in respect of the tax treatment of a collective investment structure is to ensure an equivalent tax outcome to that which an investor would face had they invested in the underlying asset directly.

14. The three main ways that returns can be distributed to investors are in the form of gains, interest or dividends. In an ideal world, an ultimate investor would be taxable on these returns in accordance with their own tax characteristics – but this is difficult to achieve in many cases when a UK AHC is used.

15. We provide more detail on some of the key challenges associated with the aspects of the tax rules in turn:

    A. Substantial Shareholding Exemption

    B. Withholding tax on interest

    C. Branch profits exemption

    D. REIT regime

    E. Financing companies

    F. Hybrid rules

*A. **Substantial Shareholding Exemption (SSE)***

16. One of the significant disadvantages of the UK as an asset holding company location is that the UK SSE regime is much narrower in scope than other countries' participation exemptions, which allow relief on disposals of both trading and investment businesses (where SSE is limited to trading entities). It is also far more complex to consider and implement – compared to the participation exemptions in countries like the Netherlands and Luxembourg that are easy to understand and give certainty to taxpayers.

17. We appreciate the need to protect the UK's tax base – and in particular, not to damage the integrity of the new non-resident capital gains tax (NRCGT) rules, which have specifically brought non-resident investors in UK real estate within scope of UK tax on gains. However, the UK could significantly improve the attractiveness of the SSE regime without damaging the integrity of the tax system by ensuring that any investment in a corporate asset whose underlying property asset is not in the UK, whether it be trading or investing, would qualify for SSE. We recognise the need to protect the tax base in respect of UK property rich AHCs and we expand on this idea in a little more detail in appendix 3, along with two other suggestions: to review the reference to 'companies' and 'shares' in the legislation; and to review and expand the existing list of QIIs.

B. Withholding tax on interest (particularly after Brexit)

18. The repatriation of income predominantly comes in the form of either dividends or income – therefore ensuring that interest can be repatriated without incurring double taxation is fundamental to an investment fund structure. This is especially important for real estate investment, which lends itself well to debt financing, given its long term, stable income flows.

19. Although certain exemptions exist in the UK in respect of WHT on interest, such as the Eurobond exemption, these require more complex/cumbersome and costly financing structures – to the extent that it is often easier to use a non-UK AHC.

20. No WHT on interest is a key selling point of the Luxembourg tax regime for AHCs – and therefore, we would advocate for the removal of withholding tax on interest. Given exemptions already exist, we would not expect this change to have a significant cost to the exchequer – and yet it would provide significant certainty to investors seeking to set up AHCs in the UK, which would greatly enhance the UK's attractiveness.

21. On a related matter, it will be important for the UK to seek a beneficial outcome in treaty negotiations in respect of WHT on interest being paid to the UK should we fall outside of the EU Interest and Royalties Directive at the end of this year. This is critical with respect to the attractiveness of the UK as a holding company location given that the benefit of the EU Interest & Royalties Directive will be lost.

C. Branch profits exemption

22. In certain jurisdictions, there may be tax, legal or commercial reasons for owning the property in that territory in a company established in that territory. However, in situations where this is not the case, and the local holding company can be established/resident in a different territory, there are currently disincentives to using a UK resident company. Some examples of where the branch profits exemption rules create challenges to using a UK AHC are set out in appendix 4.

23. The issues identified in the appendix could be resolved in a straightforward and practical manner if the UK branch profits exemption was extended to the income and gains arising from a non-UK property rental business. Given most jurisdictions have taxing rights on property income and the UK corporation tax rate is relatively low, we do not anticipate this change would result in a significant cost to the exchequer.

D. REIT recommendations

24. A well-functioning REIT regime is critical to the UK becoming a more attractive location for investment management activity. More specifically, there are a number of changes which will help make UK REITs a more viable choice of asset holding vehicle for real estate – which we have set out within appendix 2.

E. Financing companies

25. Financing companies are often used to provide a centralised finance/treasury function across a group of companies or number of funds. The appropriate return generated is typically determined with reference to an OECD standard transfer pricing review which considered the functions performed, risks borne and assets utilised in generating the return.

26. Many members have experienced a number of challenges and significant scrutiny from HMRC in respect of their transfer pricing calculations – even though they have been calculated with reference to the OECD's guidelines.

27. Certainty of tax outcome is incredibly important, in order to communicate to investors likely returns. To that end, it would be helpful to have an agreed TP methodology and published guidance which confirms what approach HMRC would support.

F. Hybrid rules

28. It is widely considered that the UK has been particularly conservative it the implementation of many of the BEPS workstreams, including the hybrid rules. We would highlight in particular that the double deductions rules and the acting together rules have had adverse consequences on collective investment structures, resulting in double taxation and compromising the position of tax neutrality.

29. We are responding to the government's separate consultation in respect of the hybrids rules and will refer you to our response for further detail on this issue.

Question 5: How are the challenges to locating an AHC in the UK, to the extent that they exist, currently overcome? How do the tax rules in other countries address these challenges?

Withholding tax on interest

30. Although exemptions exist, such as the Eurobond exemption, these often require more complex/cumbersome financing structures so it is often easier to use a non-UK Holding company. Luxembourg offers no WHT on interest, which is a compelling selling point for alternative investment funds seeking tax neutrality on repatriating interest.

Substantial Shareholding Exemption vs Participation exemptions

31. One of the significant disadvantages of the UK as an asset holding company location is that the UK SSE regime is much narrower in scope than a number of other countries that have wider participation exemption regimes, which allow relief on disposals of both trading and investment businesses (rather than just trading businesses). It is also far more complex to consider and implement – compared to the participation exemptions seen in countries such as Netherlands and Luxembourg that are easy to understand and give certainty to taxpayers.

Question 6: What impacts have recent developments in the international tax landscape had on determining where to locate an AHC? How have asset management firms so far responded to these developments?

32. The BEPS work streams (particularly BEPS action 6 on treaty abuse), have prompted many investors to re-visit and reconsider their structures and seek to locate their fund vehicles and their asset holding companies in the same place. For many European and international asset management houses, Luxembourg has been an attractive location – as have the Netherlands and Ireland.

33. The UK has typically incorporated the BEPS recommendations in a very conservative way relative to many peers, which has negatively impacted on the UK's relative attractiveness as a real estate investment hub. In particular, the incorporation of the corporate interest restriction rules and the hybrids rules has resulted in a significant additional complexity which puts the UK at a disadvantage

compared to competitors which have sought to introduce BEPS without sacrificing an understandable and stable tax regime.

Question 7: To what extent are there non-tax barriers to AHCs being located in the UK? If so, how might these dilute the impact of reform to existing tax rules intended to improve the UK's attractiveness as an AHC location?

34. For some investors, the regulatory barriers may carry more weight, although we consider that appropriate changes to the tax rules alone would have a significant impact on investor appetite to locate AHCs in the UK.

35. Some non-tax factors which will influence where an AHC in located include:

    A. Lender preference – some lenders may have a preference over which location they would like to lend to – for example, if they are particularly familiar or comfortable with the rule of law or strength of enforcement rules in one country.

    B. Investor preference – many investors will typically stick with what they are familiar with.

    C. Legacy structures - many investors will have acquired an asset already within a certain company or a certain structure (referred to as legacy structures). These structures will often remain in place because it can be difficult or costly to change a structure or migrate an AHC.

    D. Future marketability – Investors consider their exit strategy from an investment from Day 1. There is a reluctance to adopt a holding structure that is not well understood in the market or may present a due diligence risk or be otherwise unattractive to a future purchaser. Hence, it tends to be the case that the market has determined the 'typical' holding structure and many investors will rarely deviate from the market standard.

Question 8: How could the challenges identified under Question 4 best be overcome?

36. We have included potential solutions within our response to question 4.

Question 9: Do you consider that there is a case for the government to develop specific rules concerning the tax treatment of asset holding vehicles in alternative fund structures? What could those rules look like? How should eligibility be defined for qualifying fund structures and the AHCs within them?

37. It will be incredibly challenging to design a new regime which adequately captures the current investment structures – let alone a regime which is able to accommodate unforeseen future changes to the industry. Furthermore, before entering into a specific regime, an investor has to have certainty that not only they qualify for the regime, but also a future buyer would qualify as well, in order to avoid reducing the pool of investors they are able to sell to. Therefore, we believe it would be preferable to address the various challenges with other areas of the tax code in the first instance, before considering whether a whole new regime would be necessary. Furthermore, a new regime could take several years to develop – during which time, the UK risks losing further AHC's (and potentially whole fund structures) to other jurisdictions. Therefore, making improvements to the existing system also has the benefit of speed.

38. If the government is minded to pursue a new regime, it is important that this is open to as broader range of investors as possible, in order to ensure that it limits the risk of distorting otherwise commercial arrangements or limiting who an asset can be sold to. To that end, we would be in favour of a broad range of eligibility criteria that would satisfy eligibility for the regime – and would anticipate that this type of detail would be the subject of consultation in due course.

39. From a UK real estate perspective, it is particularly important that REITs and PAIFs would be eligible investors within any new regime. Furthermore, it is incredibly common for institutional investors to form joint ventures alongside other professional or institutional investors – so it would be important for any widely held test to enable a 'look through' to the ultimate investors to determine if the test has been met. There are a number of existing definitions for 'good' or 'qualifying' investors within different areas of the tax code – including the REIT rules, SSE, and the NRCGT rules – we would hope that all of these investors would be eligible for a new AHC regime if it were developed.

Tax treatment of asset holding companies in alternative fund structures

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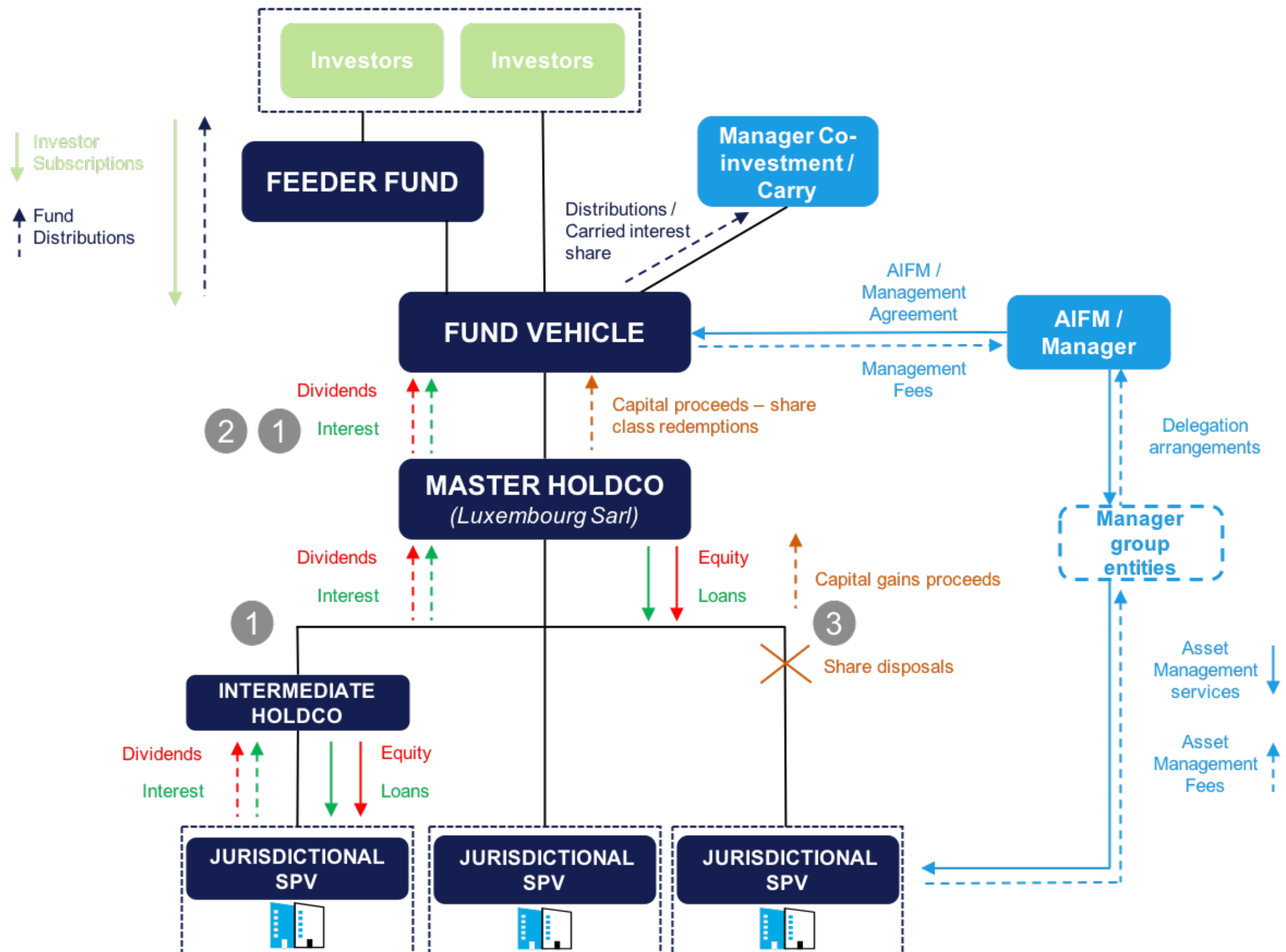
Appendix 1: Example European investment fund structure



Explanation of structure

FUND STRUCTURE

- Fund vehicle: Various types.
  [For the purpose of this consultation, we note that all the entities beneath the fund vehicle would be an asset holding company – the industry typically refers to them as 'Holdcos' or 'SPV's" (a term which typically relates to the AHC at the bottom of the structure which holds the real estate asset directly)].
- Master HoldCo: Typically a Luxembourg Sarl. Used for a variety of reasons as highlighted in the consultation paper.
- Intermediate HoldCo: Used in a number of commercial contexts (similar to the above) including as part of a common property investment structure in certain jurisdictions e.g. Sweden, Finland, Norway. May be local to SPV jurisdiction or non-local.
- Jurisdictional SPVs: These may be local (more often than not) or non-local to the jurisdiction of the property asset and may be corporate (usually) or non-corporate form.

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MONEY FLOWS – FUND AND INVESTORS

- Investors subscribe for interests in the Fund and receive distributions. Some investors may inject their investment in the Fund via a Feeder vehicle.
- Downstream of the Fund vehicle, investments are financed with a mixture of debt and equity instruments flowing through the Master HoldCo, Intermediate HoldCo and SPVs.
- Third party finance may be introduced at any layer in the fund structure.
- Returns flow back to the fund in the form of interest, dividends and capital receipts e.g. proceeds from share disposals/liquidations, share class redemptions.

MONEY FLOWS – MANAGER

- The Manager of the Fund charges a management fee. This is most often charged at the Fund level but some elements of the services provided may be charged at other levels e.g. asset management services may be charged directly to property owning SPVs.
- Management may involve delegation/advisory arrangements with other manager group or third party entities.
- The Manager may co-invest in the Fund vehicle alongside other investors (usually through a dedicated co-investment vehicle) and performance-related carry may also be extracted in this way.

UK VERSUS EG. LUXEMBOURG AS A HOLD CO JURISDICTION – KEY TAX ISSUES (NUMBERED GREY CIRCLES)

- Interest withholding: The UK applies withholding tax to interest whereas Luxembourg does not. Whilst using a quoted Eurobond can remove the withholding tax issue it is both burdensome and costly to operate relative to a simple intercompany loan agreement.
- Anti-hybrids: The UK's anti-hybrids rules are more stringent than Luxembourg's meaning that interest disallowances could arise to a UK Hold Co sat under a transparent fund e.g. limited partnership, depending on the domicile of the investors.
- Capital gains: Capital gains in Luxembourg are generally not subject to tax under the participation exemption regime. The UK's SSE regime is narrower in scope and more complicated, not always capable of applying.

[To note that we have not included a separate REIT diagram because the structures and considerations are very similar.]

Appendix 2: REIT recommendations

A well-functioning REIT regime is critical to the UK becoming a more attractive location for investment management activity. More specifically, there are a number of changes which will help make UK REITs a more viable choice of asset holding vehicle for real estate – which we have set out below.

1. **Listing requirement:** The REIT rules were amended in 2012 to accommodate scenarios where an institutional investor seeks to invest in a REIT by themselves or alongside a small number of investors (such as in a joint venture arrangement). In these cases, where the investors are widely held and also subject to high levels of regulation, it is not clear what function the listing requirement serves from a policy perspective – and yet it increases the administration and cost for setting up these types of REITs – many of which would not list, but for the REIT requirements. Listing is not a tax matter and results in REITs becoming subject to additional requirements of the applicable stock exchange only. We would recommend that the listing requirement be removed in cases where a proportion (to be determined) of the investors are qualifying investors. It should be noted that the listing requirement should always remain optional as it will be a commercial decision. REITs remain subject to anti avoidance rules and in particular s545 CTA 2010 so if listing was considered a barrier to entry to discourage inappropriate use of the regime then this is not necessary. We note that there are a number of other unlisted REIT regimes, such as the French OPCI.

2. **Close company rules:** the NRCGT rules allow the option to look through immediate investors to determine whether or not an entity is ultimately widely held. We would like to see a similar look-through approach adopted in the REIT rules. (This would help allow a REIT vehicle to be used under a widely held or institutional fund vehicle for example).

3. **Balance of business test:** this test requires that 75% of a REITs assets and income streams derive from investment assets. It is important that this test and threshold be kept under review to ensure it is not stifling the industry and continues to serve a purpose from a policy perspective – there is a general perception amongst members that the test imposes a significant burden on business and it is not clear whether it provides a significant benefit to HMRC. Given all non-REIT activity is subject to corporation tax, we believe that several helpful improvements could be made to the balance of business test with limited risk to the integrity of the rules.
    a. Exclude overseas property holdings – to attract more pan European REITs which are headquartered in the UK.
    b. Use a 3 year look back average BoB test - to avoid REITs falling foul of the BoB test because of an anomalous or unexpected transaction or event in one or more years.
    c. Ensure that any trading activity which purely arises as a result of a regulatory or planning requirement (such as Section 106 planning obligations) are treated as ‘good’ activities for the BoB test.

d. Consider a simpler initial calculation based on consolidated accounts to determine whether a full BoB calculation is required – such as a gateway test. (This would be a much simpler calculation and crucially based on consolidated accounts - and only those that do not meet the gateway threshold would be required to perform a more detailed BoB test).

4. **Pan European REITs** – as noted above, we would like to see the UK REIT regime being able to attract pan European or global real estate investment structures. In addition to the changes suggested above to the balance of business tests, the changes we propose in respect of the SSE rules and the branch profits exemption will help ensure that non-UK investors are not subject to UK tax on non-UK profits.

5. **Review list of QII's for REIT purposes** – this list should be kept under review to ensure that it is capturing investors which are widely held. Notable exclusions at the moment are US endowment funds.

6. **Exit of a single asset REIT –** if REITs were to be used as a single asset holding vehicle (e.g. for a very large office block or shopping centre), or indeed if any REIT seeks to dispose of its whole portfolio in one go, the rules would need to provide a viable route to dispose of the asset or assets in the context of an asset holding company.

7. **The three year development rule - a rebasing of the 'the fair value of the property' is needed –** we would suggest that the test should simply be whether the cost of the redevelopment exceeds 30% of the value of the (tax) fair value of the property prior to redevelopment – in order to ensure that every asset which has been held for a number of years prior to redevelopment does not fall foul of the rules by virtue of the impact of inflation on prices over time.

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Appendix 3: Substantial Shareholdings Exemption - recommendations

A. Reference to companies and shares to be reviewed

40. SSE is currently only available to a company which is selling shares in a trading company (unless it's a QII). While the reference to trading is very restrictive in itself, especially given a portfolio may well have a mixture of trading/investment entities - the reference to 'company' is also incredibly restrictive. The alternative fund investment industry is host to a number of different investment vehicles which may not have traditional share capital but may have some equivalent, such as units or partnership interests. It would be helpful if the SSE requirements in this regard could be made more flexible to reflect the diversity of investment vehicles in the sector.

41. Specifically, currently the requirement is for the company being disposed of to be a company within the meaning of s170(9) TCGA 1992. This therefore excludes certain entities deemed to be companies for capital gains purposes, e.g. certain offshore CIVs deemed to be companies under para 4 sch 5AAA TCGA 1992.

42. SSE relief could therefore be amended to include these "deemed" companies. This was discussed during the NRCGT consultations but we understand it was not possible to make any changes at the time as a review of SSE was not within the ambit of those consultations. Whilst some relief was provided under para 33 schedule 5AAA TCGA 1992, this is narrower in scope than SSE.

43. There is also currently a requirement to own ordinary share capital in the entity being disposed of. Not only does this potentially restrict the relief where, in the case of fund structures a number of different (non-UK) vehicles are typically used, this would also be restrictive in relation to the "deemed" companies (referred to above).

44. SSE relief could therefore be amended to extend the definition of ordinary share capital as with other capital gains provisions, e.g. ss135(4) and (5) TCGA 1992.

B. The second subsidiary exemption – "QII" – list to be reviewed and expanded

45. The second subsidiary exemption allows for SSE to apply on the sale of a non-trading company where at least 80% of the investors are "QII's". It would be helpful if the rules could allow some kind of look through test, to capture any intermediary companies that are ultimately owned by QIIs. Furthermore, it would be helpful to keep the list of QIIs under review and in particular, would seek to extend the QII list to the following investors:

    - *REITs,*
    - *Life companies, and*
    - *Funds which are subject to the NRCGT para 12 exemption election.*

46. The QII subsidiary exemption currently only permits tracing through entities which are companies or partnerships for the purposes of establishing the percentage of interest held in the disposing entity by QIIs. This therefore restricts tracing through other entities which are typically used in fund structures and therefore the tracing could be extended through entities which are not companies or partnerships (similar to the tracing provisions in para 46 sch 5AAA TCGA 1992).

47. To the extent that the basic SSE relief is not extended (see 1 above), the subsidiary QII exemption could be extended to disposals by and of entities which are deemed to be companies for the purposes of UK tax on capital gains (under para 4 sch 5AAA TCGA 1992) but are not companies as defined in s170(9) TCGA 1992. This would be consistent with the provisions in s535A (7) CTA 2010 in relation to disposals by UK REITs of “UK property rich” entities.

48. The list of qualifying investors for the purposes of QII SSE should be amended to remedy the existing drafting issue with life companies and extended to include entities subject to a fund exemption election under para 12 sch 5AAA TCGA 1992, and potentially include UK REITs.

C. A new subsidiary exemption for investment companies which do not meet the UK property rich test (per the NRCGT rules)

49. Whilst we appreciate that the government may not want to damage the integrity of the new NRCGT rules, the UK does not have taxing rights over non-UK property rich investments, and therefore there would be no loss to the exchequer if the SSE regime was expanded to cover investment in non-UK real estate assets. This would be a boon to the UK as a holding company location for international real estate investment structures.

50. The new subsidiary exemptions could include a carve out for “UK property rich” entities to protect the integrity of the NRCGT rules – indeed such a carve out could draw from the existing definition in schedule 5AAA TCGA 1992.

51. A targeted relief would provide scope for additional conditions/safeguards to prevent abuse in relation to this new exemption without impacting on the basic and QII SSE reliefs.

52. A new relief could potentially be restricted to disposing entities which are “non-close” companies but using broader definitions of “non-close” consistent with s.528(4A) CTA 2010 for UK REIT purposes and the definition in para 46 sch 5AAA TCGA 1992. However, for these purposes s444 should however not be disapplied (companies controlled by “non-close” companies not treated as being “close”).

53. Specific concerns regarding enveloping assets followed by a tax free disposal of shares could be addressed by specific measures, in the case of the extended SSE relief (so as not to interfere with the existing basic and QII SSE reliefs). For example, where a UK property is transferred to a company which is not “UK property rich” which is then de-grouped s179 (3D) TCGA 1992 could be disapplied to the gain under s179 TCGA 1992 on the UK property. Similarly, s782A CTA 2009 could be disapplied in relation to transfers of intangibles.

Appendix 4: Further details on challenges with the branch profits exemption

54. In certain jurisdictions, there may be tax, legal or commercial reasons for owning the property in that territory in a company established in that territory. However, in situations where this is not the case, and the local holding company can be established/resident in a different territory, there are currently disincentives in using a UK resident company. Therefore even though it may be more cost effective or easier to manage if those properties were held in a UK company, under current UK tax rules this would be disadvantageous. Some examples of this are set out below.

55. Where a UK company holds non-UK property, the profits of that entity are then subject to UK tax. In most cases, the territory where the asset is located has primary taxing rights and the UK provides double tax relief for foreign taxes paid. However, the tax base needs to be computed under both local and UK tax principles, which can lead to material differences even where the tax rates are similar. This can lead to further UK tax being paid on rental income earned outside the UK. It also results a significant additional administration which makes the UK less attractive – even though the tax take for the UK exchequer in respect of profits from overseas property is expected to be minimal.

56. In cases where the UK company owning non-UK property is a member of a group UK REIT, there is an even greater disadvantage. The income from the non-UK property is exempt from UK corporation tax under the REIT regime, and therefore there is no credit available against UK corporation tax payable. It is possible to expense the overseas tax in calculating the tax exempt income, and this will reduce the amount of the property income distribution that the REIT is required to pay in accordance with the REIT regime. Nevertheless, the ownership of a non-UK property by a UK tax resident company which is a member of a group UK REIT still results in an increase in the property distribution requirement, potentially resulting in further tax at the investor level which is likely to be at a higher rate than would apply to an ordinary dividend. This would not be the case if the property was held in a non-UK tax resident company.

57. By way of illustration, in the above example, if there is income from an overseas property of 100 taxed locally at 20%, a group UK REIT which owns the property through a UK tax resident company would pay no UK corporation tax on the income but would be required to distribute a property income distribution of 72 (90% of (100 - 20)). In comparison, if the overseas property was owned through a non-UK tax resident company, there would be no property income distribution requirement, and to the extent that the income was distributed as an ordinary dividend this is likely to be taxed at a lower rate, reflecting the fact that it is a distribution out of a company which has already suffered tax (in this case in the overseas jurisdiction where the property is located).

58. Similar issues arise in relation to the taxation of gains in relation to non-UK properties held by UK tax resident companies (for non-REITs and REITs).

59. The issues identified above could be resolved in a straightforward and practical manner if the UK branch profits exemption was extended to the income and gains arising from a non-UK property rental business.

60. For this purpose the definition in s 206 CTA 2009 of "overseas property business" (also used for the purposes of the REIT exemption referred to above (s 519 (1)(b) CTA 2010) could be utilised;

Overseas property business (s 206 CTA 2009)

A company's overseas property business consists of—

(a) every business which the company carries on for generating income from land outside the

United Kingdom, and

(b) every transaction which the company enters into for that purpose otherwise than in the course of such a business.

61. To the extent that non-UK properties are held in non-UK tax resident companies, no UK tax is currently being paid in relation to these activities. Even if the controlled foreign company ("CFC") provisions were to potentially apply (e.g. if the master holding company is located in the UK), in such cases these provisions are unlikely to result in additional UK tax being paid in respect of profits of a property rental property business carried on by such companies as the UK CFC rules provide various exclusions (e.g. s371CA (11) TIOPA 2010). We understand that these exclusions were in part due to the fact that the territory in which the property is located will in most if not all cases have taxing rights over that property income and therefore the location of the company which owns the property will not have a significant impact on the taxation of those profits.

62. Furthermore, given that the current UK corporation tax of 19% is low in comparison to many other territories, other than the somewhat anomalous consequences in relation to a UK REIT (as set out above), it is unlikely in practice that there would be any additional UK tax to pay in many cases once double tax relief is taken in to account.