Consultation on the delivery of a new regime for asset holding companies (AHCs)

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To: UKfundsreview@HMTreasury.gov.uk

Introduction and background

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

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 we welcome government's proposals to make the UK more attractive for UK asset holding companies to be used in collective investment structures, as part of their wider ambitions for the UK Fund Industry.

We acknowledge that introducing a new regime in such a short amount of time is a huge challenge, which touches on a whole host of different tax rules. We have been encouraged by the efforts of both HMRC and HMT to engage with stakeholders throughout the consultation process – and would commend their iterative and collaborative process. However, we are concerned that the regime, as proposed, will not be attractive to huge swathes of the investment management industry, unless it can be significantly simplified. We would urge government to avoid working to a tight legislative timetable at all costs – and to take the time necessary to get a regime that is fit for purpose and achieves the government's bold ambitions to bolster the UK's position as a centre for asset management services and create jobs across the UK.

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

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Structure of this response:

Consultation on the delivery of a new regime for asset holding companies (AHCs)

Part 1: Executive summary and key recommendations

1. 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.

2. In order to understand how best to design a new regime in the UK which caters to alternative fund structures, the starting point is to recognise how equivalent regimes overseas operate, and the key factors that have driven the location of so many of these fund structures to date. We have provided an example of a pan-European investment structure in appendix 1, which we hope will provide some helpful background of the primary tax and structuring considerations. In particular, investors and fund managers will place significant value on a regime which is simple to understand and comply with – and we consider that the current proposals fall short of what is needed in this regard.

3. When choosing a location for a fund structure, the fund manager will have regard for the substance of their whole structure and the suitability of the structure for all of their investments. As a major asset class, it is imperative that both UK and overseas real estate can be accommodated in the UK's AHC regime.

4. We acknowledge that the rules will require a certain level of additional complexity in order to accommodate holdings of UK real estate, while balancing the government's desire to retain taxing rights on UK property. However, the UK AHC regime should not be seeking to tax returns on overseas property, simply because they are repatriated through UK AHCs. Property all over the world is generally taxable in the location in which it is based – therefore any additional tax charge in the UK AHC structure would risk a double tax charge on the investments – and would add unnecessary additional complexity to the rules, as well as compliance costs. In order for the AHC regime to be appropriate for real estate investments, overseas property returns repatriated through a UK AHC structure should not be subject to additional UK tax.

5. We set out below a number of other key considerations and recommendations which we believe will need to be addressed in order to make the regime suitable for the investment structures the UK are seeking to attract.

Summary of key considerations and recommendations

A. Eligibility

6. The eligibility criteria are currently very complex and are likely to exclude huge swathes of investment structures. In particular, real estate investment structures do not always have an independent or regulated fund manager – so this criteria will be particularly difficult for many real estate investment structures to meet. In additional it is important that the eligibility criteria can accommodate joint venture arrangements, which are incredibly common for both real estate and infrastructure investment. We consider that a simplified eligibility criteria should be introduced where one or more qualifying institutional investors own at least 50% of a JV. Given

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

institutional investors will typically be heavily regulated, it would be sensible and justifiable to ease the eligibility criteria in these cases. Further details of our proposal for a streamlined eligibility process are included in appendix 3.

7. We would further note that the eligibility criteria would still remain incredibly complex relative to overseas equivalent regimes, and we expect that this will at least allow the government to take a pragmatic approach in other aspects of the new regime.

B. Compatibility with UK real estate

8. When choosing a location for a fund structure, the fund manager will have regard for the substance of their whole structure and the suitability of the structure for all of their investments. As a major asset class, it is imperative that both UK and overseas real estate can be accommodated in the UK's AHC regime. We acknowledge that the rules will require a certain level of additional complexity in order to accommodate holdings of UK real estate, while balancing the government's desire to retain taxing rights on UK property.

9. It is also important that the regime is able to interact with our existing real estate investment regimes, notably the REIT regime, but also the NRCGT exemption election and the SSE QII rules. This will ensure that funds with AHCs have full commercial flexibility as to what they choose to invest in – and investors are not put in a worse position by investing through an AHC structure.

C. Compatibility with overseas real estate

10. The UK AHC regime should not be seeking to tax returns on overseas property, simply because they are repatriated through UK AHCs – neither should the rules be over complicated with the requirement to apply a double tax credit mechanism. A double tax credit mechanism not only creates uncertainty over the level of tax that will be suffered in the UK – it adds additional compliance costs. Given most jurisdictions already impose tax on their own real estate, and the UK does not currently bring in significant tax revenues in respect of overseas property, it should not be contentious for the UK to confirm that no additional tax will be suffered in the UK on returns from overseas property. Indeed, we believe this would be a welcome simplicity to the UK tax rules more broadly – but at the very least, would be expected within the AHC regime.

D. Gains in the hand of investors

11. We note that currently the UK will tax investors in most overseas investment structures by reference to the distributions they receive. This approach is simple and well understood by fund managers and investors. We are concerned that considerations given to 'tracing' of gains and income for particular investors would make the regime incredibly unattractive as it would increase the complexity of running an AHC structure – and the risk taken on by the fund manager. We would expect that the stringent eligibility criteria would give government some comfort to be pragmatic and adopt a simple approach here – and we have set out further thoughts in relation to gains in the hands of investors in appendix 4. We would urge the government to be as targeted as possible when addressing their concerns. In particular, we would reiterate that as returns from real estate are generally taxable in the country in which the real estate is based, any additional rules to 'trace' these returns up to ultimate investors would be disproportionate for a property rich investment structure.

E. Withholding tax on interest

12. Interest on debt is a key mechanism for repatriating returns to investors, and therefore the regime must allow for no tax loss on these repatriations. Furthermore, we would continue to encourage the UK to consider a wider exemption (i.e. outside the UK AC regime) for WHT on interest to all UK source interest payments, except potentially in specific situations (e.g. where paid to individuals or entities in certain 'black-list' jurisdictions).

F. Entry charges

13. Any charge on entering the regime would be a disincentive to use the regime – and will therefore hamper the UK in meeting their overarching objectives – to bolster the UK's position as a centre for asset management services and create jobs across the UK.

G. Real estate is unique to other asset classes

14. Whilst we acknowledge that the new AHC regime is intended to apply to the whole alternative investment universe, this does not mean that all the provisions of the regime need to apply equally to all types of fund. In particular, given returns from real estate all over the world will typically be taxed in the jurisdiction that it's based in, real estate inherently represents a lower risk of under taxation – as such, it would be disproportionate to apply some of the mitigation measures being considered in the context of a real estate fund. We would encourage government to consider a more tailored approach that acknowledges the nuances of different types of fund – which is the approach that has been adopted by the income based carried interest rules (which were introduced in FA 2016).

H. Wider changes to the UK tax rules still needed

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

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Part 2: response to consultation questions

Eligibility

Question 1: Do you think an AHC regime should include arrangements where some or all investors invest directly at the level of the AHC, as discussed at paragraph 4.25? Can you provide evidence on how common these arrangements are?

16. Yes, the AHC regime should accommodate arrangements where some investment occurs directly at the AHC vehicle. This would occur in many joint venture arrangements, which are very common in real estate investment.

17. Furthermore, investment strategies are dynamic, so the regime will need to accommodate situations where the same investment which may evolve through a number of different ownership structures.

Question 2: Are there situations where legal agreements involving investors who invest directly at the level of the AHC are significantly different from those where all investors invest through a CIS or AIF? For example, would different investors' interests be fungible under these arrangements or could there be differences in the way some investors participate in the results of investments?

18. Yes, there can be some differences in legal agreements and share classes. Although the general trend is to have greater transparency and homogeneity between different share classes, some notable cases where differences will arise include:

    a. Some investors may have specific reporting obligations and the fund may be required provide specific financial information.

    b. Some 'side car' investors may participate at a different level in the fund structure, seeking to invest in a specific investment, rather than the returns of the whole fund (e.g. this would be common for a JV investment in real estate).

Question 3: Would a broader approach to eligibility, accommodating arrangements of the type discussed in Question 1, create increased risks of abuse or avoidance? If so, how could these be mitigated?

19. We do not consider that a broader approach to eligibility would increase the risk of abuse and/or avoidance. It is important that the AHC regime is made available to as wide a community of investors as possible in order to ensure as wide a take up as possible, particularly given that at the time a fund will need to make a decision to use the AHC regime it will know neither the profile of its investors nor the specific nature and structure of the investments it will make. We consider that the risks of abuse and/or avoidance will be very limited – especially in the context of real estate investment structures, given real estate is typically taxable where it's located. Therefore, for any potential risks that HMRC are concerned about, we would encourage targeted measures to address specific risks where possible. In addition, we would encourage government to consider a streamlined set of eligibility requirements for institutional investors, who represent significant investors in real estate – and given they are heavily regulated in their

own right, strict eligibility requirements are unnecessary. See appendix 3 for further details on a streamlined approach to eligibility.

Question 4: Is the concept of participation a suitable way to identify the investors in an AHC? Would this be consistent with the commercial reality of investment arrangements? Do you have any suggestions for an alternative approach, for example referring to the legal documents used to determine the rights of investors?

20. No comment.

Question 5: How can regime rules accommodate structures where companies fulfilling the role of an AHC are not directly owned by the ultimate investors or by another AHC?

21. No comment (although we do provide details of how we consider the AHC and REIT regimes should interact in appendix 5).

Management

Question 6: What is the best method to identify the asset manager who provides investment management services to investors in relation to the investments held by an AHC? Do you foresee complications, for example in a structure with multiple layers of AHCs? How can regime rules address these situations?

22. Many real estate investment structures have internal management capabilities – and do not rely on third parties. Therefore, some flexibility to the eligibility criteria will be needed to accommodate these scenarios. Further detail of our thoughts on eligibility are included in appendix 3.

Question 7: What tests would best ensure that investment decisions are taken by an asset manager who is subject to regulation and has genuine independence from the investors?

23. We do not consider that the regime will command wide appeal if it is only open to regulated and independent asset managers – especially given that it is common in real estate investment structure for the management function to be carried out in house,

24. We believe that a 'collective investment' test, such as a non-close or GDO test, will provide sufficient comfort that it would not be easy to facilitate tax planning for the benefit of a minority of investors.

25. However, the rules must accommodate typical commercial scenarios – such as an entity seeding their own fund, and therefore, not able to meet the 'collective investment' test until the fund is more established. In addition, it is common for an investment or asset manager to have some 'skin in the game' – although, again, a widely held fund should give sufficient comfort even in these cases.

Question 8: What would be an appropriate maximum proportion for asset managers' interests in an AHC, including interests held by individual fund executives? Can you provide details of relevant commercial arrangements?

26. The rules would need to be flexible enough to accommodate common commercial scenarios - such as on seeding new funds, and carry structures.

27. If the rules are to include a maximum proportion for asset managers' interests, we would suggest that this is no less than 10%. This maximum would need to be exclusive of carried interests, which generally work by entitling the investment fund executives to a proportion of profit higher than their ownership percentage once a hurdle is reached. Where there is a catch-up arrangement in the fund waterfall, this could be up to 100% of profit until a certain proportionate split of profit is reached.

Question 9: How should regime rules ensure that the activities of an AHC are limited to a facilitative, intermediate role between investors and investments?

28. The definition should make clear that the primary functions of the AHC are to perform a facilitative and intermediary role in channelling investment capital and returns between investments and investors.

29. However, the definition should also accommodate a deminimis threshold for ancillary trading activity, which may be performed by one AHC entity and recharged to other AHC group entities. Typical ancillary activities in a real estate investment structure would include: management services; centralised procurement; centralised compliance (e.g. tax, finance, book-keeping); treasury function.

Question 10: Can you provide evidence about any specific situations where, as part of an AHC's facilitative, intermediate role and for genuine commercial reasons, part of its activity might amount to a trade?

30. See response to question 9. Having certain functions centralised within one AHC entity should be accommodated within the regime.

Question 11: Should eligibility criteria include the requirements set out at paragraph 4.49?

31. No – we consider that these requirements would impede the ability of an AHC to be flexible to pursue commercial strategies and opportunities. At the very least, we would recommend that the above criteria are "or" rather than "and" criteria. Further comments on this are included in appendix 3.

Question 12: How could regime rules safeguard against assets and/or related income being ring-fenced for the benefit of a subset of investors?

32. Government could introduce some targeted measures if they see some aggressive practices. However, the government must be careful not to limit the ability of the AHC to use innovative financing techniques (for bona fide commercial purposes).

Question 13: Could the proposed approach to eligibility include arrangements that you believe should not be included within an AHC regime?

33. No – on the contrary, we consider that the eligibility criteria will restrict huge swathes of investment structures.

Question 14: Could the proposed approach to eligibility exclude arrangements there is a good rationale to include within the regime? If so, how might relevant structures be defined? Are there structures designed to facilitate alternative finance arrangements that could be excluded?

34. Seeking to define 'good' arrangements always runs the risk of excluding reasonable arrangements or quickly becomes a limitation where commercial realities evolve more quickly than the relevant legislation can keep up. As such, we continue to recommend that wider changes to the UK tax rules will be helpful in conjunction with the AHC regime, to ensure that there is a limited risk of a cliff edge for those that fall outside the AHC regime.

35. As we have noted above, the proposed eligibility criteria would currently struggle to accommodate any investment structures with internal management structures, as well as joint venture arrangements, which are both very common in real estate investment structures. See proposals to address these concerns in appendix 3.

36. Another example which has been raised in the consultation is the ability to establish shariah compliant real estate investment structures in the UK. At present, UK tax issues exist which preclude many shariah compliant investment structures from being established in the UK (and also hinder the operation of the Islamic Finance industry more widely). Given the alternative finance rules were written nearly 20 years ago and the growth of this sector in that time, we consider that there is merit in revisiting them to ensure shariah compliant investment structures can also be established in the UK to further support the government's ambitions.

Profit on income received by an AHC

Question 15: Can you provide evidence as to the methods and instruments an AHC might use to return income and capital sums to investors and the commercial, administrative and tax considerations that will inform this choice?

37. Dividends and interest would be the primary means of returning income to investors, as well as capital redemptions and loan repayments. The type of return will primarily depend on the investment strategy of the fund (i.e. is it a more opportunistic "value add" fund, which may return less regular capital returns, or a "core fund" returning more regular income returns?) Other factors which influence the nature of the return include:

    a. Corporate law/liquidity requirements may require interest payments to be made rather than dividends.

    b. A desire to match income and expenses in an AHC.

    c. Tax treaty and WHT treatment of dividends vs interest.

Question 16: What advantages or disadvantages could there be in allowing a broader range of deductions to calculate an AHC's profits? Do you consider that the better alternative would involve deductions for specific instruments? Or do you think the regime should take a broader approach based on the totality of amounts returned to investors?

38. No comment.

Question 17: To what extent would the outcomes discussed in paragraph 4.65-4.68 be appropriate for AHCs, and to what extent do the rules contemplated as part of the regime make these outcomes more likely? If such outcomes are inappropriate, how can regime rules ensure that an AHC is subject to tax on a suitable measure of profit on taxable income?

39. No comment.

Question 18: What is your view on the best method to ensure that an AHC cannot obtain relief for any payments to investors that would reduce its profit below an amount commensurate with its role?

40. We would consider that existing transfer pricing methodology and legislation can be utilized to ensure that an appropriate taxable profit margin is retained in the AHC.

Question 19: Can you provide information on how funds approach transfer pricing for any instruments where deductions are not currently available in the UK? Can you provide examples from existing companies fulfilling the role of an AHC to illustrate any areas of potential difficulty?

41. No comment.

<u>Capital gains realised by an AHC</u>

Question 20: Will the proposed treatment of capital gains realised by an AHC provide an effective means of ensuring that AHCs do not pay tax on gains they reinvest or return to investors?

42. We agree with the overarching proposal and justifications that an AHC should not pay tax on capital gains. However, our preference in designing the AHC regime would be to provide for a simple exemption for capital gains realised by the AHC.

Question 21: Could the relationship between the relief proposed for gains and other potential reliefs available to an AHC create undue complexity or unintended consequences?

43. We are concerned that the proposed mechanism to relieve gains proposed in the consultation is inordinately complex – both requiring application of "several interlocking reliefs" and the need to implement tracing, would create unnecessary complexity, which we do not think is justifiable based on the risks the government is concerned about. We would urge the government to allow the regime to bed in, and use more targeted measures to address any perceived inappropriate behaviours, or use of the regime in a way that was not intended.

Question 22: How could rules on relief for gains be protected from abuse in a way that is simple and easy to administer? Would a requirement of the kind discussed under 'Eligibility', that AHCs have a policy or practice of reinvesting or returning capital to participants when investment assets are sold, help achieve this aim?

44. We consider that the risk that entities within the AHC regime would be used to "artificially defer tax on capital gains" is highly unlikely – because commercially, investors would either expect their cash to be returned to them as soon as possible, or they would want to see their cash reinvested to seek returns – a fund sitting on uninvested capital would be totally uncommercial.

We would expect that any regime TAAR, or general anti-abuse rule, would prevent tax-motivated arrangements of this nature.

45. We consider that the UK Government's suggestion that AHCs have a policy or practice of reinvesting or returning capital to participants when investment assets are sold is reasonable. We anticipate that such a policy would broadly reflect the commercial reality in the overwhelming majority of situations where an AHC would be used. (We would note that any rules would need to accommodate funds which are required to hold a certain amount of cash reserves to fund redemptions – which might be more common in an open ended fund structure).

Withholding tax on payments of interest to investors

Question 23: To what extent could a WHT exemption for payments of interest by AHCs to investors create risks around the diversion of investment income to low tax territories?

46. The inclusion of an exemption for the AHC to withhold tax on payment of interest to investors is important to the attractiveness of the regime – given how common it is for interest to be used to repatriate returns to investors. We consider that the risk of such an exemption being misused are low – especially in light of the various BEPS changes in recent years.

Question 24: How could regime rules mitigate these risks? Do you think any WHT exemption for AHCs should include a purpose test and/or be limited to interest paid to recipients in qualifying territories?

47. We consider that the eligibility criteria – and in particular, the 'widely held' tests, will give significant comfort that an AHC structure would not be set up for the tax advantage of an individual or investors in a low tax territory.

48. If the government considers that further protections are necessary, something targeted at the jurisdictions that HMRC are most concerned about would be preferable (e.g. where paid to individuals or entities in certain 'black-list' jurisdictions).

49. Given the limited risk to the exchequer, and relative importance of simplicity for investment fund structures, we would encourage the government to provide a wider exemption (inc. outside the AHC regime) to all UK source interest payments.

Income and gains paid to investors

50. We are concerned that the approach set out in the consultation in relation to income and gains in the hand of investors is completely unpractical and uncompetitive. Typically, investors in funds are currently taxable by reference to the distributions they receive, whether in income or capital form – and are subject to tax if they make a gain when they dispose of their units in the fund. This is a fair, simple and pragmatic approach – and we would urge the government to avoid over complicating the design of the AHC in respect of income and gains paid to investors. We would encourage the government to allow the new regime to bed in, before considering whether any targeted measures would be appropriate to address specific concerns. We set out

our full considerations in relation to income and gains in the hands of investors in appendix 4 – which can be considered as our response to questions 25 to 31 in the consultation.

Question 25: How can regime rules ensure that amounts of income returned to investors are treated appropriately for the purposes of UK tax?

Question 26: What is your view on the most appropriate method to treat amounts as capital gains in the hands of investors?

Question 27: How should regime rules ensure that amounts designated as gains cannot displace amounts that should be treated as income in the hands of investors?

Question 28: How can an investor's interest in the AHC be appropriately valued in order to determine their proportionate share of any gains? What instruments might investors hold, with what rights attached, and how might these holdings change over time?

Question 29: Are there other areas of the tax code that could counteract the intended effect of rules to treat amounts as gains in the hands of investors or produce unintended consequences?

Question 30: How could rules to treat amounts as gains in the hands of investors be protected from abuse? Is there a streamlined test the regime could use to safeguard against conversion of income to capital?

Question 31: Should the regime allow certain types of profit on loan relationships of an AHC, such as profit on redemption or disposal of 'distressed' debt, to be treated as capital? Is there an appropriate method that could be used for this purpose?

Real Estate questions:

Question 32: Can you provide evidence on the number and type of situations where a fund might wish to use UK SPVs to own and receive overseas property income directly?

51. It is not currently very common to hold overseas property in a UK company. There are a handful of European countries, including Germany, where a property would not generally be held in an entity in that country (or a transparent entity may be used).

52. However, it could become more common with the growing pressure on ensuring substance in structures. It should also be noted that Germany is one of the larger European commercial property investment markets – so it will account for a disproportionate amount of European real estate investment.

Question 33: Given the availability of relief in the UK for foreign tax paid, to what extent would the lack of an exemption for overseas property income act as a barrier to the use of UK AHCs to hold overseas property? Can you provide any examples of specific situations affected by this issue? To what extent would this affect the choice to locate master and intermediate holding companies in multi-jurisdictional real estate funds in the UK?

53. The UK AHC regime should not be seeking to tax returns on overseas property, simply because they are repatriated through UK AHCs – neither should the rules be over complicated with the requirement to apply a double tax credit mechanism. A double tax credit mechanism not only creates uncertainty over the level of tax that will be suffered in the UK – it adds additional compliance costs (an example of the potential complexity is set out in appendix 2).

54. Given most jurisdictions already impose tax on their own real estate, and the UK does not currently bring in significant tax revenues in respect of overseas property, it should not be contentious for the UK to confirm that no additional tax will be suffered in the UK on returns from overseas property.

55. We recommend that such an exemption should apply to all UK companies that own non-UK real estate, not just AHCs, to avoid market distortions and a reduction in the attractiveness of a UK-based AHC regime, given that real estate often changes ownership within corporate SPVs.

56. We don't believe conditions should be necessary for this exemption – but if HMRC are minded to make it conditional, an initial 'Double Tax Treaty' gateway test would be simplest, with a secondary 'fall-back' test of whether or not the property income is locally subject to tax.

Question 34: To protect against the risk of loss of tax on UK property income and gains, do you think it would be appropriate for regime rules to specify that an AHC should not own UK land or UK property rich assets? To what extent could this discourage use of AHCs for multi-jurisdictional real estate funds?

57. UK real estate is a major investment class and therefore the regime must be able to accommodate UK real estate (either directly or indirectly). With enhanced focus on substance, a fund structure would be unlikely to move to the UK unless all of their investment assets can be accommodated.

58. We acknowledge that the rules will require a certain level of additional complexity in order to accommodate holdings of UK real estate, while balancing the government's desire to retain taxing rights on UK property – however, this is a necessary compromise.

Question 35: If the regime permitted AHCs to own UK land and UK property rich assets, how could rules ensure that the additional deductions and reliefs available to an AHC did not lead to any erosion of the UK tax base in UK property?

59. While flexibility to accommodate both direct and indirect holdings of UK property would give the most commercial flexibility for investors, we acknowledge that allowing direct holdings may require some degree complexity. In particular, we anticipate that allowing direct holdings of UK real estate would require the UK property returns to be 'ring-fenced' within the AHC entity, so that they remain taxable and cannot be offset by e.g. deductions on otherwise AHC-permitted profit participating instruments.

60. The rules would have to ensure that an investor into UK property through an AHC structure would not be any worse off – and therefore the rules would need to accommodate the various reliefs and exemptions that a real estate investor might be eligible for (such as SSE QII, NRCGT exemption election, group relief, deductions for expenses etc). Similarly, 'normal' UK principles should apply (including unallowable purpose, CIR, capital v revenue, wholly and exclusively rules

etc.) and group relief should be available as normal from AHC entities for costs and expenses falling outside of the AHC ring-fence.

61. If required, limited protections could be included to protect the UK tax base in an international property structure, e.g.

    a. No UK group relief available for excess expenses / deductions from overseas property businesses, assuming they benefit from an exemption. Otherwise group relief operates as normal.

    b. CIR position could exclude overseas property business exempt entities (in a similar way that QIC / PIE entities are excluded), but should otherwise operate as 'normal' (i.e. fixed and group ratios still available).

    c. We would not recommend any simplified / 'brute force' test to restrict the maximum amount of UK expenses by reference to e.g. a fixed percentage ratio.

62. Alternatively, if AHCs were prevented from directly holding UK property, this would significantly reduce the need to ringfence and stream activities (although a limited amount of ring-fencing of gains would still be required for share sale gains by AHCs). While the investor/fund would benefit from a less complex compliance, the primary downside would be:

    a. A 'corporate blocker' would be required between income or gains from tax transparent entities – which creates some additional complexity on the fund structure.

    b. Lack of commercial flexibility.

    c. It will be more challenging to achieve tax neutrality when repatriating returns from the "Prop Co", to the first AHC entity in the structure (because some of the key benefits of the AHC regime, would not apply).

Other comments on real estate investment

63. *Nature of real estate investment in the hands of the investor:*

64. Real estate funds include both 'core' funds and more 'opportunistic' funds, a key difference being the level of risk and target return (and therefore the mix of 'stable' income-producing assets, assets requiring more intensive asset management / refurbishment, development assets, buy-and-sell property trading, property management platforms, real estate backed debt interests etc.). AHCs should be able to hold (directly or indirectly as appropriate) all of these types of real estate investments: from the investor perspective these are all 'investments' and appropriate protections can be included to protect UK taxability of UK real estate activity (whether rental or trading).

65. *Interaction with existing UK RE regimes:*

66. **REIT regime:**

    a. AHCs should be qualifying 'institutional investors' for the purposes of the REIT regime (i.e. a UK property portfolio could sit beneath an AHC in a REIT structure). (Structure diagrams illustrating this potential interaction are in appendix 5).

b. Where an AHC sits above a UK REIT (either wholly or partly owned), the AHC can either choose to pay CT on the REIT PIDs received, or could elect to take on some of the REIT responsibilities and requirements (i.e. tax-exempt on PIDs received but requirement to onward distribute to investors 100% of the distribution as PIDs and comply with the REIT 'holder of excessive rights' rules).

Stamp Duty and SDRT:

Question 36: How significant is the impact of Stamp Duty and SDRT on AHC location, in particular with reference to the points listed at paragraph 4.134? Please provide details of the specific situations where the lack of an exemption would have a significant impact when deciding whether to locate an AHC in the UK.

67. An exemption from Stamp Duty and SDRT would, inevitably, increase the relative attractiveness to investors. Up-front transactional costs have a disproportionate impact upon project returns and to the extent that an exemption is made available, this would increase the overall attractiveness of the regime.

68. If there was no exemption then all other things being equal, AHCs would likely be incorporated in Jersey or Guernsey but resident in the UK.

69. Non-UK resident companies in real estate fund structures generally return capital gains to investors through a buy-back of shares or a liquidation distribution, both of which are treated as capital gains in the hands of UK investors. No stamp duty or equivalent is chargeable on those transactions and as such, in order to make the UK AHC regime attractive, an equivalent exemption from stamp duty is required on a buy-back of shares by an AHC.

Corporate groups:

Question 37: Do you have views on the government's proposed approach to group relief for AHCs?

70. If it is intended that holdings of UK real estate in an AHC structure would not benefit from the exemptions in the regime, then group relief on UK real estate holdings would be required.

Question 38: Are there other rules relating to corporate groups whose application you think should be modified for AHCs?

71. No comment.

Entry and exit from the regime:

Question 39: Should the regime accommodate entry by companies already used to hold investment assets prior to becoming AHCs? What issues could arise for these companies? How could regime rules protect against any increased risks of abuse or avoidance?

72. Yes this should be accommodated – it would avoid the need for contrived steps to change the 'wrapper' which holds investments. This will be particularly relevant where a fund within the AHC regime acquires an investment through the acquisition of a holding company and subsidiary propco. This acquisition structure is common where for example, a portfolio of

properties is acquired or the sellers want to sell the joint venture company rather than the underlying property owning companies

Question 40: In situations where a company leaves the AHC regime, how can regime rules provide against loss of tax? For example, what is the best way to ensure that gains not yet charged to tax, reinvested or returned to investors become taxable? Should this be via a deemed disposal from the perspective of the investors or via a charge in the AHC?

73. We believe this is most likely to occur in the event that a Fund sells an investment at the level of the AHC. In that case, any gain on disposal will be subject to tax in the selling entity or when returned to investors. We would urge HMRC to consider whether there are any scenarios in practice where there could be a loss of tax before introducing complicated exit provisions.

74. Consideration will also need to be given to how a company previously within the AHC regime is treated when acquired by a non-AHC purchaser. Any negative tax consequences or continuing obligations will discourage funds from using the AHC regime as the ownership structure will need to be attractive to a future owner.

Question 41: Where a company that has claimed the benefits of the AHC regime is wound up and is subsequently found not to have met eligibility criteria, what is your view on the best method to ensure that any additional tax due can be collected?

75. No comment.

Question 42: Should a new accounting period begin for tax purposes when a company enters or exits the AHC regime?

76. No comment.

Question 43: Can you provide details of any situations where an AHC might temporarily cease to meet the regime eligibility conditions? How should regime rules approach situations of this type?

77. The AHC may temporarily cease to meet the conditions in the event of a change of investors during the period that the AHC is in existence. In such instances, an AHC should be given a grace period within which to take steps to meet the eligibility conditions.

<u>Other tax issues</u>

Question 44: What situations are there where current rules in any of the areas listed at paragraph 4.148 could act as a barrier to locating AHCs in the UK? Are there any other issues the government should consider in this regard? Please provide information to illustrate the extent to which these issues could affect take-up of an AHC regime.

78. No comment.

Question 45: How should any issues identified in your answer to Question 44 be addressed?

79. No comment.

Question 46: Can you provide specific examples of existing overseas companies fulfilling the role of an AHC, in order to test the full effects of the proposed regime and of draft legislation?

80. Please see appendix 1.

Anti-avoidance

Question 47: Please highlight any inherent features of the proposed regime that you consider protect it against abuse, and set out what additional anti-avoidance rules you consider might be desirable.

81. The eligibility criteria – and in particular, widely held tests, provide some inherent protections for the regime – this safeguards against a single investor being able to dictate the structure of the investment fund for their own tax advantage.

Reporting and monitoring

Question 48: What information, either listed in paragraph 4.156 or otherwise, do you think HMRC should collect to maintain the AHC regime as low risk and provide a high-level understanding of how it is used?

82. No comment.

Question 49: Do you have suggestions for an XBRL taxonomy for these items? What are your views on whether tagging would be a convenient and reliable method to ensure that information is provided?

The information listed in para 4.156 covers both fund level information and entity level information. Some of the information should only need to be provided once, when the Fund elects into the AHC regime. To the extent that HMRC requires company-level information on an annual basis, it may be appropriate to gather that information from the company's tax return or from its accounts. We would note however, that the more information that is required to be provided specifically for AHC purposes, that is not generally prepared by a UK company or at Fund level, the less attractive the regime will be.

Consultation on changes to the REIT regime

Listing requirement

Question 50: Who should any relaxation of the listing requirement apply to? If there is a relaxation for institutional investors, how could this be applied? What are the benefits and risks of applying a relaxation where institutional investors hold less than 100% of the REIT and where should any cut off point be set if relaxing the requirement for REITs only partly held by institutional investors?

83. From a policy perspective, any relaxation of the listing requirement should apply where it serves no commercial purpose, as it imposes an unnecessary financial, regulatory and administrative burden in those cases. In particular, it serves no purpose at all where a REIT is beneficially owned by a small number of institutional investors, who are generally widely held and subject

to high levels of regulation. A feature of such REITs is they do not raise capital on the public markets and do not require any trading in their shares.

84. A relaxation of the listing condition for institutional investors should be linked to the relaxation of the close company condition found in Section 528(4)(b) CTA 2010. An obvious benefit of this is that the 'cliff edge' for the relaxation of the listing condition for institutional investors would essentially be the same 'cliff edge' as that for the close company condition.

85. As a useful reference point, relaxation of the listing condition for REITs owned by institutional investors was considered from a policy and legislative perspective for the purposes of the Substantial Shareholding Exemption ("SSE") in Schedule 7AC TCGA 1992. Paragraph 3A(6) of Schedule 7AC, which was inserted by F(No.2)A 2017, defines "qualifying UK REIT" as:

86. *"…a UK REIT within the meaning of Part 12 of CTA 2010 which -*

a. *meets the condition in section 528(4)(b) of that Act (company not a close company by virtue of having an institutional investor as a participator), or*

b. *by virtue of section 443 of that Act (companies controlled by or on behalf of Crown) is not treated as a close company."*

87. Please note that Paragraph 3A(6)(b) is required because technically a REIT controlled by or on behalf of Crown does not need to rely upon the institutional investor relaxation in Section 528(4)(b) CTA 2010 in order for a REIT not to be a close company. We are concerned, however, that Paragraph 3A(6)(b) does not cover other situations where companies are not close, e.g. where they are controlled by more than five institutional investors such as overseas governments etc. (as set out in CTM60280) or pension funds. We would therefore suggest that:

a. the definition in Paragraph 3A(6) is used as the basis for the relaxation of the listing condition in Part 12 CTA 2010; but that

b. an additional subsection is introduced to cater for companies that cannot be controlled by any persons who are not institutional investors (which for this purpose should also include overseas governments); and

c. it is important, of course, that the 'partner attribution provisions' in Sections 448(1) and 451 CTA 2010 are switched off for these purposes, as institutional investors frequently co-invest into REITs via a limited partnership and potentially with the fund managers (who will not be institutional investors).

88. We would suggest that the listing relaxation in the SSE rules is then brought into line with the improved version used for the REIT rules.

89. Any relaxation of the listing condition must be able to accommodate situations where institutional investors hold less than 100% of the REIT. For example, it is commonplace for a fund manager to set up a REIT for the purpose of acquiring an asset or portfolio, with the fund manager investing alongside the institutional investors and potentially taking a carried interest which depends upon the performance of the REIT's assets. There are also multi-investor situations where funds constituted as limited partnerships coinvest in a REIT and not all the ultimate investors (which may be numerous) in those limited partnerships are institutional investors. We believe that these situations are adequately catered for by the existing relaxation

of the REIT close company condition for institutional investors in Section 528(4)(b) (and therefore the listing relaxation in SSE for "qualifying UK REIT"), so no further artificial cut off point needs to be introduced.

Question 51: What would be the benefits and risks of a complete removal of the requirement for listing?

90. As the listing requirement is not a tax matter, prima facie, complete removal of the listing requirement would be appropriate. Those companies that list for commercial reasons, for example to raise capital on the public markets, would still choose to list. Those that don't, would not list and would benefit from the removal of the unnecessary financial, regulatory and administrative burden that a listing imposes.

91. However, there are clearly indirect benefits of requiring a listing – notably greater regulation, transparency and a high standard of corporate governance are considered to be helpful for the general reputation of the regime – and are likely to be attributes that HMRC place some value on. It would be helpful to better understand the importance of these indirect benefits for HMRC – and consider whether similar outcomes could be achieved in a more targeted way. We consider that this question warrants further debate, although we do not think it is necessary to make a decision on this point along the same timeframes as the other AHC changes, but rather allow a longer period of time for sufficient consultation and consideration of the pros and cons.

92. As a general comment, many REIT regimes around the world allow for unlisted REITs (e.g. the US, Australia, Netherlands, Japan). Indeed, the description of a REIT in the OECD Commentary to Article 10 of the Model Tax Convention, does not include being listed as one of the broad characteristics of being a REIT.

Institutional investors and the close company requirement:

Question 52: Are there any further investor groups who should be added to the list of institutional investors? Why should these investors be added, including the expected impact and are there any additional tax issues that would need to be considered?

93. The aim of the institutional investors list is to include UK and overseas widely held entities only, preserving the non-close status of the REIT. There are, however, a vast number of different types of overseas entity that are widely held and satisfy the policy intent of the institutional investor list, but unfortunately some of them do not fit within any of the specific categories on that list.

94. The institutional investor list is necessarily brief and prescriptive, and it would be impractical to accommodate the plethora of different widely held overseas institutional entities in primary legislation or in regulations. We therefore suggest the introduction of an additional 'principles-based' category of institutional investor that reflects the policy intent of the list. Any taxpayer who is uncertain whether an investor satisfies the requirements of the principles-based category could obtain clearance from HMRC under the Non-Statutory Clearance procedures and HMRC could publish a list of such overseas entities in guidance, along the lines of the List Of Classifications Of Foreign Entities For UK Tax Purposes in HMRC guidance at INTM180030.

95. We do not think that there would be any additional tax issues of introducing an additional principles-based category.

96. Notwithstanding our suggestion regarding the introduction of an additional principles-based category, we would like the following categories of entity explicitly added to the institutional investors list:

    a. Non-UK Charities / Endowments (e.g. in particular, US university/educational endowments, which are significant investors in UK real estate funds and joint ventures);

    b. Authorised Contractual Schemes (ACSs), both UK (under section 261D(1) FSMA 2000); and non-UK (e.g. a common vehicle for pension funds to invest is via a Luxembourg Funds Commun de Placement (FCP));

    c. Subsidiaries of qualifying overseas REITs (particularly since it is not uncommon for those interests to be for 10% or more, and so cannot be held by a single corporate entity (such as the overseas-elected REIT) due to the Holder of Excessive Rights provisions);

    d. Listed investment companies (i.e. companies with shares that have been admitted to trading on a recognised stock exchange and whose primary activities are investment and not trading); and

    e. Overseas government bodies or wholly owned and controlled bodies of overseas government.

97. On a related matter, it is a longstanding anomaly that a REIT is treated as a close company despite being controlled by a non-close company. The reason for this counter-intuitive outcome is that the normal close company test in Part 10 CTA 2010 is modified for the purposes of the REIT close company condition in Section 528(4)(c) CTA 2010 by subsection (5), which treats a company as close if it is prevented from being a close company only by section 444 or 447(1)(a) CTA 2010 (relaxation for a company controlled by non-close companies). Such a REIT, controlled by a non-close company, clearly fits within the policy intent of preserving the non-close status of a REIT and we suggest that subsection (5) is repealed. The type of arrangements that subsection (5) was originally aimed at are now prevented by the subsequent enactment of the Real Estate Investment Trusts (Prescribed Arrangements) Regulations 2009 (SI 2009/3315) which can be broadened if necessary to the extent that any particular type of non-close company arrangement were to be considered abusive in the context of a full repeal of subsection (5).

Question 53: When considering a look through approach as part of the close company test, should this work in a similar way to the NRCGT rules or would this need to be modified to work with the REIT rules? If the rules would need to be modified, what changes should be made?

98. We agree that a look through approach as part of the close company test should work in a similar way to the NRCGT rules, particularly the “indirect participator” concept in Paragraph 46(7) Schedule 5AAA TCGA 1992. There are, however, various aspects of the approach used for the NRCGT rules that could be improved for the purposes of the REIT close company test. Furthermore, we would suggest that the references to sections 444 and 447(1)(a) in Paragraph 46(2)(b) and (c) in Schedule 5AAA TCGA 1992 should be removed (as noted in our response to Question 52 above).

Question 54: Would a change to the rules for overseas equivalents of a REIT encourage overseas investment through UK REITs? What difficulties may there be in establishing that an overseas company satisfies the requirement to be equivalent? Are there any risks arising from such a change?

99. A change to the rules for overseas equivalents of a REIT would remove an impediment for overseas investment through UK REITs. In practice, it has proved to be very difficult for taxpayers and HMRC to agree how the term "equivalent" should be interpreted in the context of overseas REIT regimes, which invariably have different detailed conditions from the UK REIT regime; some more relaxed and some more stringent.

100. In our view, an overseas entity should be treated as the equivalent of a UK REIT if it has the broad characteristics of a REIT as generally is described in the OECD Commentary to Article 10 of the Model Tax Convention. The broad characteristics are:

    a. A widely held company, trust or contractual or fiduciary arrangement, that

    b. derives its income primarily from long-term investment in immovable property,

    c. distributes most of that income annually, and

    d. does not pay income tax on the income related to immovable property that is so distributed.

101. HMRC's interpretation of the rule for an overseas equivalent of a UK REIT is that the rule refers to the overseas regime being equivalent, rather than the overseas entity. We would suggest that the legislation in Section 528(4A)(j) is amended so that it clearly refers to the overseas entity being equivalent to a UK REIT and, in order to be equivalent, that entity needs to have the characteristics set out in the OECD Commentary to Article 10 of the Model Tax Convention.

102. It is worth noting that there is recently enacted legislation based to an extent on the OECD characteristics for a REIT, which can be found in Paragraph 1 of Schedule 5AAA TCGA 1992 in the context of the definition of collective investment vehicle for NRCGT. However, there are a number difficulties around the interpretation of these provisions and we would not recommend using it for the purposes of Section 528(4A)(j) in the REIT legislation.

103. We would suggest that the above approach based on OECD characteristics is adopted rather than require an overseas REIT to demonstrate that it would qualify as a UK REIT were it to be UK resident, as this could involve a significant compliance burden for it to demonstrate that it meets all of the detailed UK REIT conditions, in addition to the conditions of its own REIT regime.

Holders of excessive rights rule

Question 55: Are there any different ways in which this rule could be changed that should be considered? If so, please explain how, the reasons for such changes, and identify the impacts and risk.

104. The purpose of the Holder of excessive rights rule is to ensure that shareholders do not benefit from a reduced rate of withholding tax under Double Taxation Agreements ("DTA"), which often allow corporate shareholders holding 10% or more of the capital of a company to receive

distributions without suffering any withholding tax, or only being liable to a reduced rate of withholding tax.

105. Consequently, certain shareholders who can be paid dividends gross (e.g. UK resident companies) are forced to fragment their shareholdings or create other complicated structures solely to remain under the 10% limit. We would suggest that UK resident shareholders who can be paid gross should excluded from the charge under the 10% rule.

106. A benefit of such a change would be to obviate the need for such shareholders to create complicated and costly structures solely to remain under the 10% limit. There are no tax risks as UK resident shareholders would not, in any case, be entitled to a reduced rate of UK withholding tax under a DTA.

107. An additional point regarding the holder of excessive rights rule, is that HMRC's guidance at IFM22105 in relation to sovereign immune entities should put be put onto a proper statutory footing.

108. A related point is the additional and unnecessary burden imposed by the obligation to deduct withholding tax from PIDs paid to overseas shareholders, such as persons with sovereign immunity and overseas pension funds, who can reclaim UK withholding tax in full, either by virtue of sovereign immunity or under a DTA. It also imposes a significant administrative burden on HMRC in terms of processing the reclaims. We would suggest that persons with sovereign immunity and overseas pension funds that can make a full reclaim for withholding tax under a DTA are added to the list of persons to who can be paid gross, as set out in Regulation 7 of Real Estate Investment Trusts (Assessment and Recovery of Tax) Regulations 2006 (SI 2006/2867 as amended).

The balance of business test

Question 56: Which of the reforms suggested, or combinations of them should be considered? Are there any other ways in which the balance of business rules could be reformed in order to reduce burdens while maintaining the principles of the REIT regime? How might these apply in practice?

109. We consider that the balance of business test should be reformed so that there is an initial 'gateway test' based on consolidated accounts, to determine whether a more detailed calculation is required for the accounting period in question. In the vast majority of cases, this would obviate the need for any further work to be carried out as most REITs comfortably pass the test every accounting period. There is no tax risk involved because any assets and income that do not derive from investment in property are subject to corporation tax anyway.

110. In the event a more detailed calculation is required, it is important that the balance of business test is reformed so that it treats activities that are ancillary to investment activities, such as those that arise purely as a result of regulatory or planning requirements, or from meeting environmental standards (e.g. meeting net zero carbon targets). Indeed, a similar concept for dealing with ancillary activity can be found in the Corporate Interest Restrictions legislation in Section 436(1) TIOPA 2010 (Public Infrastructure Exemption).

111. It is also important that the detailed calculation avoids failure due to anomalous or unexpected transactions, or, for example, 'lumpy' trading profits made on the disposal of a development. For this reason, we would suggest using a 3-year average in the case of a REIT that otherwise fails to pass the balance of business test. We also think that a breach of the Balance of Business

Profits test should be ignored, at the very least, for the first accounting period (perhaps the first three accounting periods to cater for situations where investment assets are in their development phase), in the same way as it is for the Balance of Business Assets test by virtue of Section 556 CTA 2010.

112. Regarding the possibility of excluding overseas property holdings from the balance of business test to attract more pan-European REITs; as noted in the Consultation Document, this could have a positive or negative impact depending on the circumstances. Our suggestion is that it should be possible to elect for overseas property to be ignored for the purposes of test, potentially revocable after a certain period of time.

113. More generally, however, there needs to be fundamental reform of the way the detailed calculation for the balance of business test is carried out as it requires voluminous and tortuous calculations to be performed each accounting period, for each and every member of a group UK REIT, which may amount to hundreds of companies in a large group. We would suggest that HMRC works together with the property industry to simplify the way in which the detailed calculation works.

Additional potential changes to the REIT regime to align with the proposed AHC regime

114. We note that the consultation document says the government intends to take forward other areas of the REIT regime that may benefit from reform as part of the wider funds review. However, there are two specific areas that we consider would merit being considered alongside the AHC proposals as they relate to matters that are equally applicable to both AHCs and REITs:

Treatment of REIT income and gains paid to investors

115. Despite the REIT regime seeking to place investors in the position they would have been in had they invested in property directly, it is a long-standing anomaly of the regime that exempt capital gains realised by a REIT are treated as income profits of a UK property business in the hands of investors, i.e. underlying capital gains are converted to income at investor level.

116. This is of particular relevance to UK resident individuals (where capital gains tax rates are lower than income tax rates) and qualifying overseas pension funds (who would be exempt from non-resident capital gains tax under section 271(1A) TCGA 1992 but may suffer withholding tax on REIT property income distributions).

117. Given the consultation document proposes that amounts returned to investors in an AHC that are attributable to capital gains realised within the AHC should be treated as capital gains in the hands of investors, we would suggest consideration should be given to aligning the treatment for REITs.

118. We would suggest that a REIT could separately stream 'income PIDs' and 'gains PIDs' based upon the existing attribution of distribution rules in s550 CTA 2010, in both cases still generally subject to basic rate withholding tax. In the same way that section 548(5) and (6) currently treat PIDs as profits of a UK property business, similar provisions could treat 'gains PIDs' as chargeable gains accruing on the disposal of interests in UK land. For overseas investors, we would expect 'gains PIDs' to still be regarded as 'dividends' from a DTA perspective so that treaty withholding tax rates would be applicable for treaty-based investors, with an ability for overseas pension funds to make a full reclaim of withholding tax based upon section 271(1A).

Treatment of overseas property profits of UK resident companies within a REIT

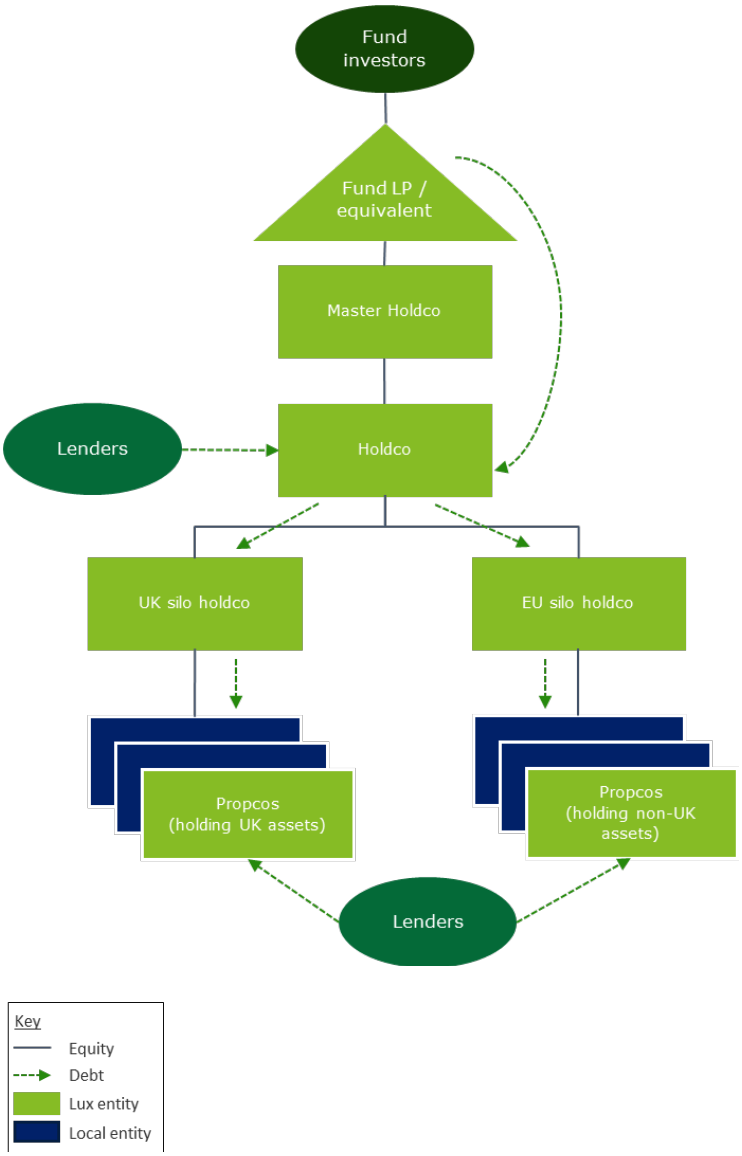
119. Currently, overseas property profits and gains of UK resident companies within a REIT fall within the REIT exemption. This results in the overseas property profits comprising part of the REIT's mandatory 90% distribution requirement, and both the profits and gains constituting property income distributions subject to deduction of withholding tax, and taxation, as and when distributed.

120. Due to the operation of the REIT rules, it is not possible to apply credit relief (as there is no UK tax within the REIT), and therefore relief for overseas tax is only available on an 'expense' basis.

121. We have recommended in this response that UK companies owning overseas property and owned by an AHC should benefit from a full exemption from UK tax on their overseas property business profits and gains. We would similarly urge that within a REIT there should be a full exemption on such profits and gains but with those overseas profits and gains then being capable of being distributed as non-PIDs rather than PIDs.

Appendix 1: Example fund structure in Luxembourg

122. There are a variety of different 'AHC' regimes in overseas jurisdictions, including Luxembourg, the Netherlands, Jersey etc. some of which are regulated and some of which are unregulated. The diagram below illustrates a common pan-European real estate Fund structure using unregulated Luxembourg Sarls, and the key tax attributes and considerations of such a structure. (Note that this is necessarily a simplified example, and fund structures are typically more complex). In order to be attractive and competitive, any UK AHC regime would need to deliver (in a simple and accessible way) equivalent benefits.



Policy area	Current position
Eligibility: Investors	• No eligibility / ownership requirements • No external fund manager requirements • Accommodates carried interest, co-investment, operating partners, club deals, single managed accounts etc.
Eligibility: Entities	• No eligibility requirements or activity limitations (ring-fencing applied as needed)
Entry charge	• No entry charge
Overseas property	• Exemption on profits and gains (generally based on DTT)
Capital gains on share sales	• Exempt (subject to limited conditions)
Dividends received	• Exempt (subject to limited conditions)
Financing	• Generally taxed only on a margin (subject to TP)
WHT on interest	• No WHT on interest
Investor taxation	• Investors taxed based on the economic returns on the instruments in which they hold an interest based on the fund's own determination of how to deliver returns (e.g. capital returns on shares or loan principal repayments, dividend returns, interest returns etc.) • Funding structures generally allow investors' invested capital to be returned first • No direct tracing / attribution of underlying exempt gains to investors

123. Under the 'status quo' position (i.e. where asset managers would currently choose to structure via a competitor jurisdiction such as Luxembourg, the Netherlands, or Jersey) the UK tax take would essentially be zero, other than (a) for UK resident investors in the fund who would generally be taxed solely based upon the capital/dividend/interest returns they receive, subject to existing anti-avoidance rules (e.g. carried interest rules, disguised investment management fee rules, offshore fund rules, transaction in security rules) and (b) for underlying UK property income and gains. A UK corporate investor in a fund would typically expect the UK dividend exemption to apply to dividends received (even where sourced from underling tax-exempt capital gains).

124. Therefore, with respect to any UK AHC regime:

a. Investors should not be 'worse off' than under the 'status quo' non-UK structure. For example, (a) funds should have flexibility on how and when to return cash to investors and investors should generally be taxed on those returns in the same way as if received from a non-UK based structure subject only to any applicable existing anti-avoidance rules, (b) a UK corporate investor should still expect the UK dividend exemption to apply, (c) the NRCG rules should apply in the normal way, (d) the QII SSE rules should apply in the normal way etc.

b. The UK should have no interest in seeking to tax activities which it otherwise wouldn't be generating significant tax revenues from (given the wider non-tax drivers supporting the introduction of a UK AHC regime). For example, given non-UK property holdings would generally currently be held in non-UK companies a general exemption for overseas property income and gains (even if held in a UK company) should be uncontentious.

c. The UK tax base should remain protected by the existing extensive UK anti-avoidance rules, and additional AHC-specific anti-avoidance rules should generally not be required 'on top'. For example, the conditions for the dividend exemption, the offshore fund rules, the transactions in securities rules, the carried interest rules, the disguised investment management fees rules etc.

125. For completeness, we note that changes to UK corporate law may be required to improve the attractiveness of the UK as a location for AHCs and to provide flexibility for e.g. the return of capital to investors.

Consultation on the delivery of a new regime for asset holding companies (AHCs)

Appendix 2: Overseas property income – example of a 'credit mechanism' approach for German property.

2. See below examples of German real estate held either by a non-UK Propco (Luxembourg, Netherlands, or Jersey) vs. held by a UK Propco with a credit mechanism.

3. **<u>German property held by a non-UK Propco</u>:**

Rental income	€1,200,000
Direct property costs	€200,000
Interest costs	€500,000

German taxation

- Full deduction for interest costs, so tax base €500,000
- Tax at 15.825% is €79,125.

Non-UK taxation

- Luxembourg / Netherlands – exempt under local law / DTT
- Jersey – taxable at 0%

4. **<u>German property held by a UK Propco</u>:**

Rental income	€1,200,000
Direct property costs	€200,000
Interest costs	€500,000

German taxation

- Full deduction for interest costs, so tax base €500,000
- Tax at 15.825% is €79,125.

UK taxation

- Assume interest limited to 30% EBDITA i.e. €300,000, so tax base €700,000.
- UK corporation tax at 19% is €133,000, less credit for German tax of €79,125 results in additional UK tax of €53,875.
    - Note other differences could include deprecation, application of local hybrid rules, etc.
    - Incremental compliance costs.

Consultation on the delivery of a new regime for asset holding companies (AHCs)

Appendix 3: Eligibility

5. We are concerned that the eligibility proposals within the consultation are complex and restrictive – and could exclude a wide range of typical real estate investment structures. In particular, our primary concerns are in relation to ensuring that the eligibility rules can work for joint venture arrangements, which are incredibly common in relate estate investment - given the bulky and illiquid nature of the investments. We are also concerned that the requirement to use an independent fund manager could exclude huge swathes of real estate investment structures, where it is more common for this function to be carried out 'in-house'.

6. We would further note that equivalent regimes overseas do not have such strict eligibility criteria (if any), so we remain concerned that retaining such strict criteria could diminish the attractiveness of this new regime. Therefore, we have put forward a proposed alternative approach below which we hope will both give comfort to the UK in relation to the structures which will be eligible for this new tax regime - whilst also ensuring that the eligibility criteria does not inadvertently exclude huge swathes of real estate investment structures.

Three stage test:

7. Our alternative proposal is for a three-stage test – which would include the following tests (which will all need to be met):

   A. *A collective investment test - is the fund catering to a large number of investors?*

   B. *A regulation test – is the fund structure regulated in some way?*

   C. *An "allowable activities" test – to show that the primary activities of both the AHC (and the wider group that it is part of), are to carry out investment and not trading activities.*

A: The collective investment test

8. As noted in the consultation, the fund would need to meet a non-close test or a GDO type test (we would note that there are deficiencies with the NRCGT GDO test that we'd want to address for this set of rules).

9. We would agree with the proposal in the consultation, that the AHC would be deemed to meet this test, if the only reason it fails the test is by virtue of having one of more "qualifying investors" (i.e. recognizing the collective nature of many of these investors). See below for details of relevant institutional investors.

B: The regulation test

10. We have proposed two possible options to meet this test – which we hope will better accommodate joint venture arrangements, where it is particularly uncommon for the JV entity to have a regulated manager – however, it is very common for at least one of the JV partners to be an institutional investor which is already subject to high levels of regulation in their own right. To that end, we would expect that government could be comfortable to provide an alternative regulation requirement as we set out in option 2.

11. ***Option 1***: The AHC is owned by a fund with an independent and regulated fund manager (as per the government's proposals).

12. ***Or, option 2*****:** The AHC is at least 50%* owned by or controlled** (directly or indirectly) by one or more "good" investors. "Good" investors would include anyone on the REIT QII list and SSE QI list as well as certain other eligible institutional investors, and in particular should include investors which are heavily regulated in their own right, and may often have in house management functions – including (in each case including both UK and non-UK investors):

    1. REITs
    2. Life companies
    3. Pension funds
    4. Sovereign wealth funds
    5. Charities / Endowments (e.g. US university endowments, which are significant investors in UK real estate funds and joint ventures)
    6. A new 'listed investment company' category (Definition to be considered, but something like "Companies with shares that have been admitted to trading on a recognised stock exchange and whose primary activities are investment and not trading").

    *We would recommend that a threshold of at least 50% would be a more appropriate threshold than 75% (as considered in HMT's recent note in respect of eligibility). 50/50 joint ventures are incredibly common in real estate investment – therefore, this threshold would ensure that the majority of commercial arrangements involving an institutional investor would be accommodated by the regime. Furthermore, we would note that the REIT rules and NRCGT exemption election effectively allow for a 50% ownership of a qualifying institutional investor to be eligible for these regimes, and some consistency with existing regimes would be helpful.

    **To note that the definition of "control" would need to be carefully considered to ensure it accommodates carry / promote structures and arrangements.

    Independence of the manager:

13. We note that option 2 does not specifically include a requirement for any fund manager that is independent from the AHC – as this function is commonly carried out in-house in many real estate funds (and the same would apply to JV entities). However, we believe the 'collective investment' criteria at A above, should give government sufficient comfort that there is genuine independence between an individual investor and the investment decisions taken on behalf of the fund or AHC.

14. There is a further complexity in cases where asset managers are required to invest directly in the AHC to align incentives – and it is important that this commercial practice can be accommodated. Again, we would suggest that the collective investment test and the allowable activities test should give government sufficient comfort that decisions could not be taken to benefit a minority investor.

C: An "allowable activities" test

15. The suggested purposes outlined in para 4.49 give an indication of the kinds of activities that HMRC would like to include –

    I. A minimum amount of capital raised for investment by an AHC
    II. Investment of capital in accordance with a defined investment policy, and
    III. A policy or practice of reinvesting or returning capital to participants when investment assets are sold

16. Our primary concern is in relation to the second bullet – as having an investment policy is a hallmark for the AIFM regulations – and as such, could bring in a fund into these regulations that would otherwise not choose to be. We also have reservations in relation to including a threshold for a minimum amount of capital invested, which seems very arbitrary and will simply be a barrier to entry (and could also cause challenges at the point a fund is being seeded or closing).

17. Therefore, at the very least, it would be preferable if the hallmarks suggested in 4.49 were 'or' rather than 'and' criteria – and for a further definition to be include with focuses more on the intermediary and repatriation functions that AHC regime is aimed at. Alternatively, it would be helpful if government could be more specific in respect of the kinds of purposes/activities or structures that are not the intended user of this regime. For example, if the intention is to exclude a trading MNE from setting up an investment arm in a new AHC silo, it may be appropriate to include a test which specifies that.

    Trading activity:

18. On a related matter, we note that while the overarching aim of the regime is to facilitate the flows of capital in an investment structure, we believe that a certain amount of ancillary trading activity will need to be accommodated in the regime. For example, it would not be uncommon for one AHC entity in a group to carry out some ancillary functions (such as investment management/asset management, procurement, or accounting and finance functions), and recharge these costs to other group members. Assuming these are ancillary to the primary purpose of the structure, we believe a deminimis threshold would be a simple way to address this – or alternatively, some form of ringfencing for any activities which should not qualify for the benefits of the AHC regime and be subject to normal UK tax rules.

Consultation on the delivery of a new regime for asset holding companies (AHCs)

Appendix 4: Income and gains in the hands of investors

19. The treatment of gains in the hands of investors is a notable area where the AHC proposals seem to take a more complex approach compared to equivalent regimes overseas. At present, other than some notable exceptions, such as the Offshore Fund rules, most investors would simply be taxable by reference to the returns they receive from a fund. We are concerned that the approach outlined in the consultation, particularly the consideration given to tracing income and gains, could be inordinately complex and would place additional tax compliance risk on the fund manager. In the context of real estate investment in particular, this would be completely disproportionate to any risk of an investor obtaining an unintended tax advantage, given real estate returns are typically taxed in the location where the real estate is based – and direct investors would generally be able to seek double tax credits.

20. While we acknowledge the overarching aim of the design of the regime is to ensure that collective investors are in a no better or no worse situation than direct investors, a pragmatic solution will be needed to balance this objective against the risks of significant complexity. We consider that a far simpler and pragmatic approach is justifiable – and set out a number of considerations below.

21. **Key points:**

    Status quo:

22. With the exception of funds that fall within the offshore Fund rules, UK investors are currently taxed by reference to the distributions they receive from overseas investment funds. This is a very simple approach for both the fund manager and the investor. By requiring some level of tracing of underling income and gains, this would be totally out of line with equivalent overseas regimes. Furthermore, by taking a different approach, UK investors would bizarrely be incentivised to use offshore investment structures over UK structures.

    Precedent for a more pragmatic approach:

23. We would note that there is already precedent in other UK tax regimes to take a pragmatic approach where the majority of investors meet a certain qualifying criteria – including the Investment Trust regime, the SSE regime, NRCGT exemption election, and the REIT regime.

24. Given the strict eligibility criteria proposed for the AHC regime, this should give government sufficient comfort to take a pragmatic approach in order to avoid disproportionate complexity.

    Risk for fund managers:

25. As well as complexity, allocating returns according to income and capital creates a significant additional risk for the fund manager, which will be a significant deterrent to using the regime.

    Real estate investment does not pose a risk of being under-taxed

26. Income and gains from real estate are already taxable in the UK and most overseas investment jurisdictions. Therefore, it would be particularly disproportionate to apply significant additional complexity to investment structures which invest predominantly in real estate.

Comments on HMT's 'Final Response Guidance' of 15th Feb

27. ***Individuals:***

28. Approaches similar to the offshore fund reporting fund regime and the transactions in securities legislation are being considered to provide comfort that appropriate amounts are distributed to UK individuals in income form.

29. While we continue to consider that this would be unnecessary for the reasons set out above, at the very least, this obligation should not be imposed on funds where the risks to the exchequer are lower - e.g.:

    A. where the fund has no (or very few) UK investors; or

    B. where the fund invests primarily in real estate (as this is typically taxed in the local jurisdiction).

30. Furthermore, given not all funds will make regular distributions, any approach which deems distributions to have taken place will need to ensure that investors do not incur a dry tax charge (e.g. any tax payment could be deferred to align with when distributions are actually received).

31. ***Corporates:***

32. The document considers that a UK corporate that invests via an AHC could get a benefit when gains are returned in dividend form (as the dividend exemption would apply). The options being considered in HMT's note include tracing of underlying gains in the underlying investment, and taxing UK corporates on their proportionate interest, or switching off the distribution exemption for UK corporates.

33. As above, it is important for government to take a pragmatic approach – and we would agree with the comments in relation to holdings of immovable property, which are typically taxable in the local jurisdiction, and a double tax credit would normally be available to a direct investor - so the risk of a collective investor achieving a better tax outcome through an AHC structure would be very low. Therefore, we would recommend that any restrictions should not apply to property rich investment structures. Furthermore, it's important to ensure that UK REITs are not inadvertently hit by any generic restrictions on corporates – to this end, the UK SSE QI list should be reviewed and broadened.

34. While we continue to consider that the options being considered are disproportionate to the risks, we would recommend that any restrictions of this nature are only imposed for significant corporate shareholders (such as those with >25% ownership) – we consider this would be a pragmatic compromise to avoid imposing this significant compliance burden on all funds. Furthermore, we would recommend that government only consider introducing such restriction once the regime has been in place for some time, and there is some evidence of how the AHC regime has been used by UK corporates.

35. ***Repurchase of share capital:***

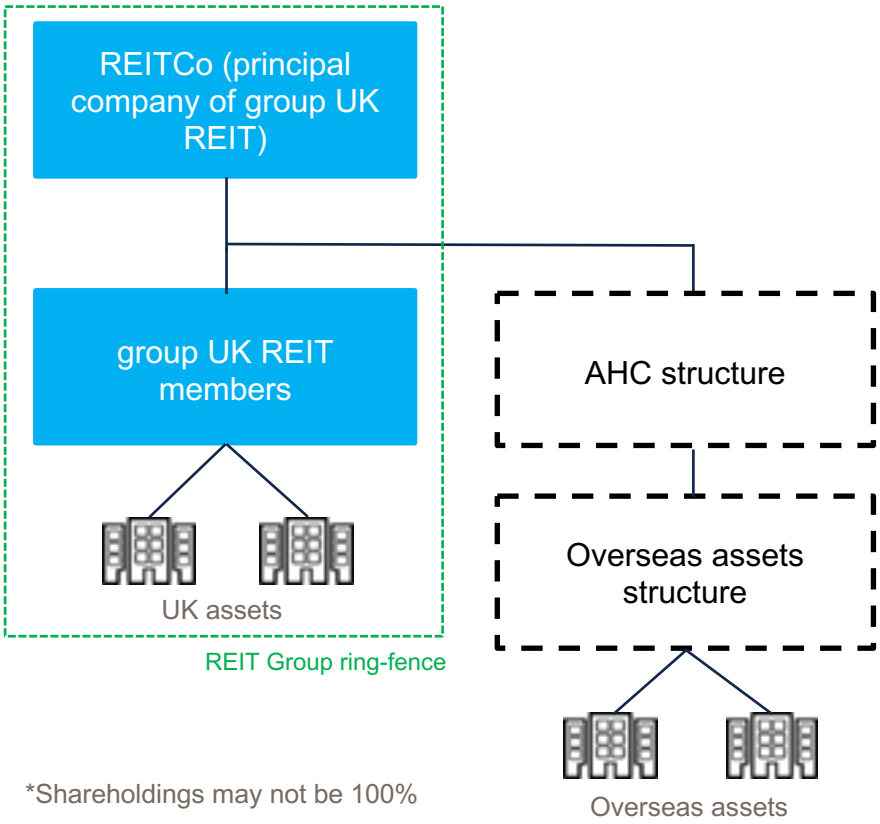
36. As raised in the note, we would agree that it is common for amounts to be returned to investors as capital via a repurchase of share capital. In order to ensure that this can be accommodated in

the UK, addressing any tax barriers should be done in conjunction with a review of corporate law in the UK, to ensure any other barriers, such as those in relation to distributable reserves, can also be addressed.

Appendix 5: Illustrations of how the REIT and AHC regimes could interact

37. The AHC regime will need to interact with the REIT regime, to enable commercial flexibility which would allow either a REIT company to hold an AHC entity, and vice versa. Example illustrations of each scenario are below.

Scenario 1: REITCo holds AHC



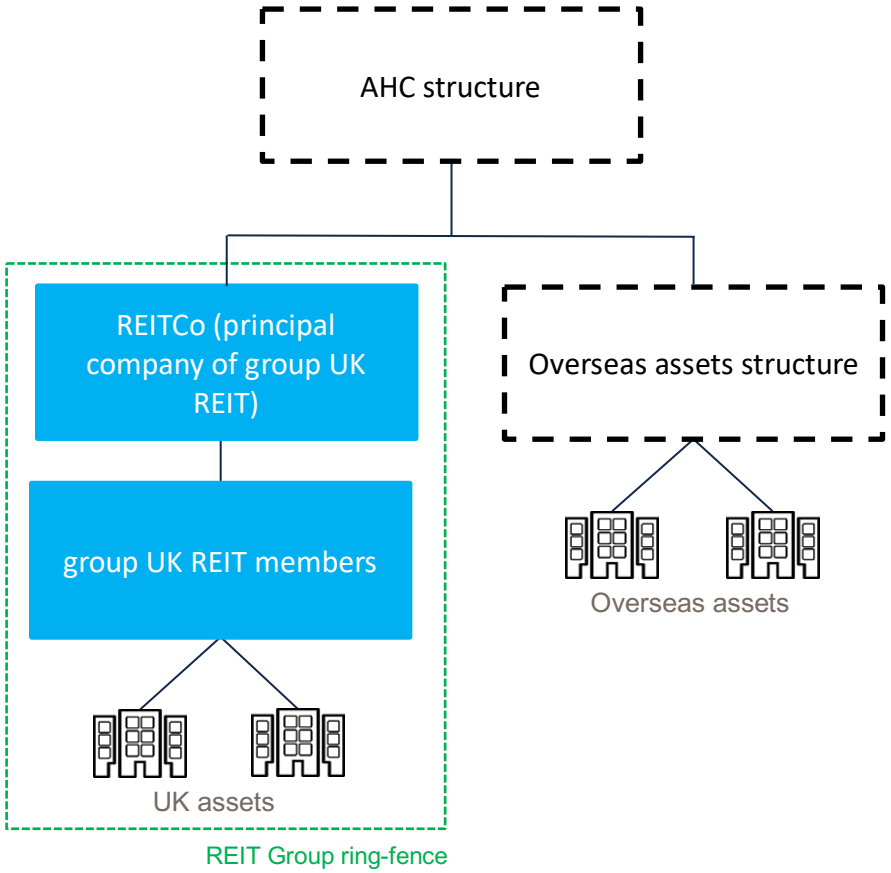
Notes for scenario 1:

38. REITCo should qualify as an "institutional investor" for the non- close company condition in AHC regime.

A. AHC must not cause any additional tax leakage on income and gains arising from the overseas assets that flow through the AHC structure, when compared with typical holding company structures in other jurisdictions (e.g. typical Luxembourg holding company structure illustrated on separate slides)

B. This might require an extension the REIT capital gains exemption in order to achieve this (depending upon the final shape of the AHC regime)

Scenario 2: AHC holds REITCo and overseas structure



Notes for scenario 2:

39. AHC qualifies as an "institutional investor" for the purposes of the REIT non-close company condition; and

Scenario 2A:

40. AHC elects to:

A. distribute 100% of any PID that it receives from REITCo; and

B. assume certain obligations of REITCo, namely:

40.B.1. the obligation to deduct withholding tax as appropriate from distributions that it makes to investors; and

40.B.2. operation of the 10% rule;

40.B.3. in return for being exempt from corporation tax on any PIDs received from REITCo

C. REITCo still has 90% distribution requirement, but can pay PIDs to AHC gross (as it's a UK resident company)

D. AHC will be able to return overseas gains etc. to shareholders using profit-participating loans etc. as usual (separate from REIT PIDs)

Scenario 2B:

41. AHC does not make an election, therefore PIDs made to AHC are subject to corporation tax (i.e. fall outside of the AHC 'special rules').

42. The usual REIT rules apply to the operation of the UK REIT e.g. 90% distribution requirement for PRB profits, but no need to distribute exempt gains.