Hybrid and other mismatches

To: hybrids.mailbox@HMRC.gov.uk
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Introduction and background

1) 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.

2) We welcome efforts from HMRC to seek to address challenges with these rules where they are creating uncertainty or restricting tax relief where this was not intended. Given the bulky and illiquid nature of commercial real-estate, it is particularly common to invest via collective investment schemes, to allow investors to share risks and pool resources. We are therefore particularly keen to ensure that these rules do not damage the ability of collective investment vehicles to achieve tax neutrality for their investors.

3) In this regard, we would draw out three important points:

    a) The rules must work appropriately and proportionately for investment funds and in particular, exempt investors should be able to invest collectively without incurring additional tax costs.

    b) Although the scope of the consultation is relatively narrow, we have included in our response some more general comments in relation to issues that arise under the UK's hybrid rules for real estate investment funds. We set out examples of these issues (which include issues relating to certain typical lending structures) within Appendix 2, to illustrate where these restrictions can be imposed on otherwise commercial and third party arrangements. We hope these will be helpful in the context of the government's wider review of the UK funds regime, and in particular, the recent consultation on the tax treatment of asset holding companies.

    c) The 'Acting Together' rules are very broadly drafted and may catch a number of third party arrangements – including otherwise unconnected investors or lenders in a fund. Again, we believe these rules could be better targeted to ensure that third party investors and lenders are not brought within the hybrid rules.

4) Please do not hesitate to get in touch if you have any follow up questions in respect of our comments – we look forward to engaging further as the proposals evolve.

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

Appendix 1: Response to consultation questions

Double deduction

Q1. Can you identify and describe in detail structures that are disproportionately impacted by the double deduction rules due to their also involving inclusion/no deduction income? Please provide full group/jurisdictional context, nature of entities and scale of impact.

5) The issue that the Consultation Document touches on arises in relation to a relatively common fund management structure used, in particular, by US fund management groups with a UK subsidiary. In many cases, the UK subsidiary (UK FM) will have been the subject of a US check the box election made by its US parent (US FM) and so will be a hybrid entity with the US FM the "investor" within s259ID TIOPA. Expenses of UK FM will therefore be brought into account for tax purposes by both UK FM and US FM and hence Chapter 9 is relevant.

6) The commentary in the Consultation Document (particularly in paragraphs 2.8 to 2.12) indicates that this type of structure, and the issues that arise under the UK's hybrids rules is one that has been discussed by HMRC with those engaged in the funds sector previously (whether formally, through representations or informally, through discussions with individual taxpayers and their advisers). The introduction of s259ID in Finance Act 2018 was, we understand, partly in response to representations made on the issues affecting these structures during the informal consultation referenced at paragraph 1.8 of the Consultation.

7) However, the drafting of s259ID - which requires the "investor" in the hybrid entity to be the person that makes the relevant payment to that entity, means that s259ID is not applicable to a number of groups where the main fund management entity (that pays sub-fees to the UK subsidiary) is not the "investor" (as defined in s259BE(4)). This is because of how groups have structured their operations (and therefore the direct and indirect ownership of their subsidiaries).

8) An additional issue arises in relation to the "in direct consequence" condition in s259ID to which the Consultation Document refers. By way of (simplistic) example, assume an investment management agreement between US FM and UK FM, under which fees will be paid to UK FM for investment management services which are provided (indirectly) to one or more funds managed by US FM. Investors in each fund (who are ultimately the recipient of those services) will be third parties (and so "unrelated") - though for completeness the US FM may itself have an interest in a fund - such interest forming (in effect) part of its remuneration.

9) Taking each condition of s259ID in turn. Conditions A, B and D should each be met. But in relation to Condition C, the position is less clear because of this requirement.

10) Investors in a fund will pay a general management fee with US FM determining the extent to which that fee is retained by it, or (in substance) is passed onto to any sub-manager (including UK FM). As far as investors are concerned, there is unlikely to be any direct correlation between payments to the US FM and to the UK FM, even though the payments are linked commercially.

11) We note HMRC's view of this provision as set out in guidance at INTM557085:

"The phrase 'in direct consequence' is not defined and takes its ordinary meaning i.e. an effect that is a result of an event or occurrence suggesting something that follows on, there is a prescribed order to the events."

12) This raises the concern that HMRC would not accept that the payment of fees to UK FM by US FM would be "in direct consequence" of the payment to US FM by investors (notwithstanding that the investors in the fund are third parties and the fee paid to UK FM is connected with that third-party arrangement).

Q2. Can you identify which of the conditions of section 259ID are too restrictive? If a case could be made such that these were to be amended, what level of evidence of inclusion without deduction or disproportionate outcomes would you suggest is necessary?

9) See response to question 1 above.

10) It seems to us that the case for a legislative solution to these issues has been already accepted taking into account the changes made in Finance Act 2018 (which recognised the need for amendment). It is because those changes do not fully alleviate the problems identified to HMRC, that we consider further amendments are needed.

11) The issue arises because the drafting of s259ID does not fit neatly with the nature of the commercial relationships and structures within fund platforms. Further, the guidance on Part 6A TIOPA contained in HMRC's International Manual (particularly that at INTM557085) does not provide much assistance in terms of the application of s259ID in practice to particular fact-patterns.

12) The fact that fund management groups have had to learn to "live" with the hybrid rules over the last 3 years, and in that context some groups may have identified ways of mitigating their effect (through, for example, a restructuring of the group) does not obviate the need for legislation. Whether or not mitigation is possible (and in some cases, commercial, regulatory or cost issues may mean that it is not), the effect of these provisions in a fund context is increased costs to try and manage the cost of tax disallowance in relation to what, in substance, is an arms' length arrangement between the fund manager and its subsidiaries to a minimum.

13) (The arrangement between UK FM and US FM will be "arms' length" taking account of both the transfer pricing rules and (if applicable) the investment manager safe harbour. Chapter 9 distorts that arms' length arrangement by disallowing the costs incurred by UK FM to generate that arms' length fee. Further, we note that the fund management fee is ultimately sourced from third party investors: they pay the US FM who chooses to sub-delegate certain management activities. The arrangement is therefore within the "intent" of s259ID, if not the drafting.)

14) If the UK is committed to looking to attract funds and/or fund asset holding vehicles to the UK, then these issues should be dealt with transparently through a change in the law, supported by clear guidance. And the result of that change in law must be legislation that is clear and can be readily understood by taxpayers and their advisers (so that guidance is focused on practical examples, not just trying to explain what the legislation actually means). As HMRC will be aware, a taxpayer seeking to understand the impact of the UK hybrids rules needs to have access not only to skilled, technical UK tax advice given the complexity of the rules, but requires their adviser to understand US (or other jurisdictions) tax rules as well as the commercial background to the taxpayer's business structure: we therefore do not consider adding to the complexity of the UK rules would either be helpful, or conducive to any broader messaging around the UK as a location of choice for the funds sector.

15) In terms of evidence of inclusion etc, it would be preferable if the conditions would be drafted so that the tax-payer can self-assess (as is now the case with s259ID) – and be as clear and straightforward as possible for the taxpayer to apply in practice.

Q3. What would be the impact of utilising non-hybrid entities in these structures so that no counteraction would be required? Please consider and describe any economic, regulatory and foreign tax impacts.

16) No comment save to note that, the OECD Explanatory Statement (October 2015) states that the intention behind BEPS2 was to neutralise a mismatch, but not otherwise interfere with the use of hybrid entities. Issues within the drafting of s259ID may potentially interfere with the use of a hybrid entity in circumstances where there is no BEPS risk in practice.

Q4. Are foreign owned groups able to get relief for additional tax arising in the UK in consequence of applying the hybrid rules? If not, why not?

17) A RE fund structure will commonly involve a partnership structure as the vehicle through which investors hold their interests in fund investments. The partnership will set up individual companies to hold specific investments (SPVs). The fund may "check the box" for those SPVs in order that an investor's tax position is as close as possible to that which would appertain were the investor to hold the property directly.

18) An SPV that owns UK real estate as an investment (as a rental property) is within the charge to corporation tax whether or not it is UK resident for tax purposes (as a result of Schedule 5 Finance Act 2019). If the hybrid rules apply to the SPV, then the fund investor will be an "investor" in the SPV for the purposes of s259ID (given that SPV is owned through a partnership) and the SPV will be a hybrid entity.

19) Many, but not all, of those who invest in RE funds are tax exempt investors (including pension funds and sovereign immune investors). As such investors are "exempt" in their domestic jurisdictions there can be no "double deduction" issue. However, if the UK's hybrids rules nevertheless apply to the SPV, any additional UK tax payable because of the application of the hybrid rules represents an absolute cost for them: no foreign tax credit will be available for obvious reasons. This has the effect that the fund is no longer able to put its (exempt) investors in (as close to) the same tax position as they would have been in had they invested directly.

20) Further, if the reason for the application of the hybrid rules is linked to the existence of exempt investors in the fund, then not only are they not able to obtain a tax credit for additional UK tax, but their presence means that all investors have a tax cost (not fully recoverable as a credit). This is because the after-tax profits of the SPV are allocated between all investors by reference to the proportionate interests in the fund - and so the additional tax is shared between all (including exempt investors): the lack of an ability to hypothecate a disallowance attributable to a particular type of investor means that the economics of the fund are distorted by the hybrid rules.

21) See also response to questions 12 to 14 below.

Q5. What mitigating steps have businesses undertaken in the 3 years since Part 6A came into effect?

22) See answer to question 2. Some businesses may have taken steps to mitigate, but that has implications for them in additional costs and complexity. As a result, the possibility of mitigation is not a justification for not taking steps to amend the legislation to make s259ID fit for purpose. Further, for some groups, mitigation may not be possible - whether for commercial, regulatory, cost or other issues.

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Q6. What impact have other jurisdictions' corporate tax reforms had on the extent of the use of hybrid entities?

23) No comment: this question may perhaps be best answered by the OECD which is monitoring the implementation and impact of its BEPS2 recommendations. However, we note that the OECD, in its recent report to the G20 in July 2002, commented that "it is challenging to measure the impact of these changes [i.e. BEPS2] on ATP behaviour".

24) The OECD also highlighted the importance of countries sharing information to ensure "consistent, comprehensive and coherent outcomes" from BEPS2-related measures. As the UK was one the first countries to legislate to incorporate the BEPS2 recommendations within domestic law, it seems that now may be the optimum time for HMRC to consider how other jurisdictions have dealt with these types of issues - to identify any possible room for improvements within the UK framework (particularly in relation to the approach taken by EU member states who, like the UK, are subject to ATADII). We note here that the OECD emphasised the importance of achieving consistency as between jurisdictions in how they implemented the recommendations.

Q7. Would a broader change, enabling inclusion/no deduction income to be treated in the same way as dual inclusion income for the purposes of the double deduction mismatch rules, be a more appropriate solution to the concerns raised? In considering this point please consider the consistency of any proposal with OECD principles.

25) Appropriate targeting of s259ID so that it works sensibly in the context of commercial arrangements within fund management groups may be all that is needed in this context. However, we would be happy to comment on any specific legislative proposal around inclusion/no deduction income that would alleviate some of the issues with s259ID highlighted in the Consultation Document, but would emphasise the importance of targeting any such measure appropriately and the need for clarity and (ideally) simplicity in its drafting. In any event, however, we do not consider such a change would address the broader concerns we have concerning the impact of the hybrids rules on funds that invest in commercial real estate and risks simply adding further complexity and potential uncertainty in this area.

26) For real estate funds, s259ID represents just one aspect of the UK's hybrid rules that is problematic in terms of impact on the economics of the fund structure.

27) Whilst it is disappointing that this consultation has a narrow focus on issues which have been raised with HMRC previously, we acknowledge (and welcome) that the concurrent HM Treasury consultation on the tax treatment of asset holding companies in alternative structures: "encourages stakeholders to provide evidence on any issues that hybrid mismatch rules create for AHCs within investment funds and how these issues might have been overcome in other countries' approaches to transposing the BEPS recommendations".

28) We therefore set out in Appendix 2 a summary of issues resulting from the UK's transposition of the BEPS2 recommendations into UK tax law that impact UK holding structures of real estate funds. These issues arise from the definition of "dual inclusion income" alone (s259ID is irrelevant in each of these cases).

29) These relate to:

a. Issues that arise in funds where a property is financed through both senior and mezzanine debt. Deductions for interest on the mezzanine debt generally arise in a different company (Mezzco) to that which holds the real estate (asset holding company or AHC).

b. Issues arising from timing mismatches where asset holding company (AHC) raises development finance (so deductions arise in periods in which the AHC does not recognise any income for tax purposes - i.e. because it is not carrying on a property rental business whilst development activity is being undertaken).

c. Issues that arise in certain Opco/Propo structures.

Acting together

Q8. Do you recognise the concerns raised and consider that a change would be beneficial in better targeting the application of the hybrid rules? Please identify and describe the circumstances that reflect these concerns.

30) We agree that the “acting together” rules within Part 6A TIOPA are drafted broadly, and so can have the effect that parties who have not “bound themselves together in such a way that there is a control relationship akin to that which would arise if they were connected” can be taken to be acting together for these purposes.

31) We note that a similar test is included within the corporate interest restriction rules, although the impact of “acting together” in that context is more limited (given the various exceptions/safe harbours in Chapter 11 of Part 10 TIOPA (which puts beyond doubt that certain commercial arrangements cannot result in parties being related): for example, s470 TIPOA which applies to ordinary independent financing arrangements).

32) The Consultation Document includes, at paragraph 3.9, two situations which HMRC state “give rise to acting together”, saying that in both “there would likely be arrangements between the third party and the parent” that would fall within s259NC(7) TIOPA. It is unclear from the following text whether HMRC is saying that these two situations “do” give rise to acting together: the use of “would likely” suggests that either (a) it has been suggested to HMRC that there may be an issue here, but HMRC have not yet had to conclude on the point or (b) the nature of the legislation is such that it is not possible to express a definitive view. In either case, we consider that suggesting that such normal commercial arrangements entered into as part of a financing arrangement “would be likely” to result in a hybrids connection (such that a legislative solution is the only option) is unhelpful, and potentially prejudicial: particularly as it is not clear that this is the correct interpretation of the rules. Taking each in turn:

Loans subject to inter-creditor agreement:

33) Covenants in an inter-creditor agreement are generally intended to recognise the priority to be afforded to payments to the third-party lender (or as between third party lenders) and any intra-group arrangements. They are additional to any “waterfall” provided for in the loan itself, with their focus instead being on what happens as and when there is a default under the loan (so for example, the third party lender has the right to determine when to enforce security and the steps to be taken - with any intra-group lender precluded from taking steps to accelerate or enforce its debt until the third party has been paid out).

34) The inter-creditor agreement therefore has the effect, contractually, of limiting steps to be taken by an intra-group lender, but this is generally contingent on something happening to trigger its operation (i.e. a default). The loan however will have been entered into on the assumption that default is not anticipated.

35) The first point to make therefore is that it seems difficult to say that there is an arrangement that relates to the exercise of rights by T in U (using the defined terms from the legislation where T is the intra-group lender) unless and until that arrangement is "live" (such that T's rights are actually fettered in practice): i.e. a default has occurred.

36) Secondly, we note HMRCs guidance at INTM550620:

> "Take for example, a company (U) which has more than one loan, and the lenders (P and T) are unrelated. Each lender is likely to act in a way that protects its investment, which might also have the incidental effect of protecting the investment of the other lender. On its own, an alignment of separate interests of this sort will not generally be sufficient to show that P and T are acting together, whereas concerted action taken by P and T would be."

37) As between intra-group lender and third-party lender, there will generally not be concerted action and limited (if any) alignment of interest (save that both parent and lender want the borrower to not default) - the purpose of the inter-creditor agreement is to prioritise the rights of the third party over and above the rights of the "equity" investor (the parent). What is said in the Consultation Document therefore appears to contradict HMRC's own guidance: there is no reference in the Consultation Document as to why HMRC seems to now be taking a different view on this issue (if that is how the discussion in the Consultation Document should be interpreted).

38) The Consultation Document continues to state:

> "In some cases – most arguably in relation to an inter-creditor agreement designed to ensure that a loan from a parent company is fully subordinated to third party debt – those arrangements are also likely to be designed to affect the value of the parent's rights in relation to the subsidiary too."

39) The test within s259ND(7)(c)(ii) is whether "it is reasonable to suppose" the arrangement is designed to affect the value of T's rights or interests.

40) What affects the value of T's interest is in substance the existence of the third-party debt. As above, the inter-creditor deals with what happens if there is a default. In those circumstances, if the borrower company is solvent, T's loan would be paid out in full - there may be a delay, but this may link mainly to the steps that need to be taken to enforce (and assuming there is sufficient cash available, T should in principle be paid out the same time as the third party). If subordination in this way has a significant impact on the value of T's interest, that is most likely to be where the borrower is insolvent. That insolvency follows on from the performance of the borrower (which is something that T has control over as parent) - the inter-creditor agreement means that T's debt is more likely to lose value than the third-party loan in such a case, but the reason for any loss of value is outside the inter-creditor agreement. On this basis, it does not seem "reasonable to suppose" the arrangement is designed to affect the value of T's interest: it is designed to protect the third party's ability to recover the amount paid to it in priority to other creditors (including T) in the event the borrower has insufficient funds to repay all its debts.

Loans including group-wide behavioural covenants:

41) Real estate finance often involves non-recourse lending to a single purpose vehicle, and so most covenants and undertakings are related to the activities of that vehicle (and not the wider group). Where covenants concern other group members, these will often be covenants to procure that the borrower does or does not do 'x': effectively "belt and braces" in support of what the borrower has

itself agreed to do or not to do. We assume HMRC agrees that such covenants are not within s259ND(7)(c).

42) There may however be broader group covenants (more akin to standard corporate lending terms). These covenants relate to protecting the lender's interest and are generally "negative" (linked to not incurring additional debt/maintaining an EBITDA ratio etc.). The purpose of these covenants is to protect debt-service - ensuring that if something happens that means the borrower's ability to repay could be at risk, the lender has the right to step in and take action if required. Group-wide covenants generally therefore address the risk that the borrower's ability to repay could be impacted by other things done (or not done) by other companies in the group.

43) Under the legislation, the requirement is that the arrangement relates to "the exercise of any of T's rights in relation to U". Such group covenants do not concern the exercise of T's rights in U (they do not impose an obligation on T to appoint directors of U, vote its shares in a particular way). Neither do they impact the value of U as such.

Parent company guarantees:

44) As above, within real estate (and particularly within real estate funds), as finance is often provided on a non-recourse basis, parent guarantees are rare. Non-recourse funding effectively allows each particular investment to operate on a stand-alone basis.

45) However, this is subject to an exception in relation to development finance, where the lender will often look to the parent to "stand behind" the borrower's development obligations. This is because where the borrower is a newly formed single purpose vehicle, it does not have the reserves to deal with problems if/as they arise.

46) These guarantees are generally focused on credit issues (so the parent commits to funding additional costs for example) so are unlikely to fetter the parent's exercise of control over its subsidiary. However, if there were covenants that fettered "to some extent" the parent's control of its subsidiary, the comments made at (b) above apply equally here.

55) In any event, see response to Q9.

Q9. What modifications do you consider would address your concerns and how would you anticipate these acting in practice?

56) If there is any concern that commercial arrangements entered into in connection with a third-party financing arrangement to protect a lender's interest could result in that lender "acting together" with a true equity investor in the borrower (and therefore being seen as related and/or part of the same control group within s259NB due to having a 50% investment), we consider that s259ND should be amended.

57) We set out below two possible modifications: first, an express safe harbour for independent commercial lenders and the second, the introduction of a materiality threshold (in line with the OECD's original recommendation for this provision). In responding to this question, we have focused on the OECD's recommendations in this area, rather than other UK legislative tests relating to control and attribution of rights, given that the provisions within Part 6A dealing with "acting together" (like those applicable to the corporate interest restriction) are derived from the OECD's final BEPS reports (and not existing UK rules, despite a significant degree of overlap). However we acknowledge that HMRC may also wish to consider possible precedents from existing UK rules unrelated to BEPS in this context.

Independent commercial lending safe harbour

58) The most straightforward way to do this (and thereby avoid further ambiguity or uncertainty as to the position) would be to add a new s259ND(10) to exclude from "acting together" any (protective) arrangement entered into by a person (the lender) who (but for s259ND(7)(c)) would not be a related party of the investor where the arrangement is entered into for the purposes of an ordinary independent financing arrangement. This could additionally be linked to that financing being entered into by the lender in the ordinary course of its business as such as additional protection for the Exchequer, and that the financing is not a structured arrangement or a hybrid instrument. The type of arrangement this is intended to cover could be either listed (in part) in the subsection by way of an "inclusive" list (i.e. including an inter-creditor agreement etc.) and expanded on in guidance.

59) This borrows from the corporate interest restriction rules (which is also OECD BEPS based) and puts on a statutory footing the position as set out in the guidance. The "but for" also preserves the argument that such an arrangement would not in any event fall within s259ND(7).

60) In practice this would ensure that a lender that is making a vanilla loan to an entity, with no more than the standard loan protections, cannot be regarded as related to a borrower simply by virtue of that loan. This would provide certainty to borrowers - and address the issue highlighted in the Consultation Document relating to the difficulties for a borrower in obtaining the type of information from an independent lender that the hybrid rules require it to obtain.

61) Any such safe harbour would, in common with the corporate interest restriction rules, need to apply to all independent lenders (and not just banks). This is because, particularly in the real estate finance market, lenders can include life insurance companies and debt (or credit) funds. Debt funds will generally lend through structures that, in common with other funds, may have entered check-the-box elections - and so the lender entity could potentially itself be a hybrid vehicle. But as its hybridity links to the debt fund's status in relation to its investors, and not to achieving some arbitrage vis-a-vis the borrower, it should not by itself give rise to a hybrids issue for the borrower. (We note that OECD Final Report on BEPS 2 said that its focus was on mismatches that rely on a hybrid element to produce a particular outcome: a mismatch (if any) that arose as a result of the debt fund's hybridity may be intended as between that debt fund and its investors (and any counteractions under a particular Chapter of the hybrids rules should target that arrangement), and not as between the debt fund and its commercial borrowing relationships with third parties.

62) Although such an exemption from "acting together" is not referenced as such in the OECD Final Report on BEPS2, the OECD recommendation was that the "acting together" test now reflected in s259ND(7)(c) be based on parties entering into an arrangement "that has a material impact on the value or control" of the relevant interests (Recommendation 11.3). The OECD comments that the inclusion of a materiality threshold is to prevent a person being treated as part of a common holding arrangement "simply because the [person] is party to a commercially standard shareholder or investor agreement that does not have a material impact on the ability of a holder to exercise ownership or control over its equity or voting interests" (section 374). The types of arrangement referred to in the Consultation Document, entered into as part of a commercial independent financing, do not have a material impact on equity rights (and are not in any sense a "common holding arrangement"): the only time that a material impact could be felt is if the borrower defaults (and the lender has to enforce security to obtain "control" of equity in the borrower) - and it seems that exclusion of such arrangements (subject to the necessary conditions) is therefore within the OECD's recommendation.

Materiality threshold

63) If such an exemption is not possible, then we ask that HMRC consider implementing the OECD recommendation fully, so that s259ND(7)(c) includes the materiality threshold that is part of Recommendation 11.3 (whether generally, or in the context of lending arrangements only), with guidance then being used to provide taxpayers and advisers with "real-life" examples of its application in practice (taking account of the OECD's edict that the rules must be drafted "as simply and clearly as possible so that they can be consistently and easily applied by taxpayers" (section 297)).

Q10. Are there any other commercial arrangements which should be considered in the same way as loans and guarantees as described above?

64) See response to Q8. It would be helpful to understand why HMRC considers that its guidance no longer reflects the application of s259ND(7) in practice to be able to answer this question (if that is the correct reading of the discussion in the Consultation Document).

Q11. Having regard to the purpose of the legislation, can you identify and describe any situations potentially caught by the other heads of the "acting together" test in sections 259ND(7)(a), (b) and (d) which in your view should be modified? How would you suggest these rules should be modified and why?

Equity-holder rights (s259ND(4) TIOPA)

65) The test for 25%/50% investment looks at "equity" rights (share capital and voting) but also at equity holder rights (see s259ND(4) TIOPA.

66) If Q (within s259ND(4)) is a borrower that owns UK land, on an assumed winding up, a single lender may be entitled to the relevant percentage of assets by virtue of its rights as creditor and as mortgagee under a fixed charge of that land. In s464 TIOPA (in the context of corporate interest restrictions), there is an exclusion for rights under normal commercial loans when applying the equivalent equity-holder test. A similar exclusion should apply under the hybrid rules (at least in relation to Chapter 9 – and at least where the lender would not otherwise be connected with Q). Here, the OECD commentary on this requirement is that it is directed at "the value of any equity interests" which is said to be "an entitlement to profits or eligibility to participate in distributions". The interests of a lender under a normal commercial loan to is repayment of amounts owing under that loan: the legislation should confirm that this does not make it an equity holder.

Collective investment vehicles

67) The OECD recommendation is that investors should be treated as acting together if their investments are managed by the same person or persons (Recommendation 11.3(d) and section 377). This is reflected in s259ND(7)(d).

68) Funds with the real estate sector vary in size. Some may have less than 5 investors; others may have many more – most, if not all of which, will have a portfolio stake in the fund (and therefore its investments) (i.e. less than 10% and possibly less than 5%). Although the fund manager has "control" of the investments of the fund on their (collective) behalf, their role/interest is purely passive. Plus no one investor will have the ability to direct the manager to take any particular action.

69) Their objective is to achieve a return from their investment – to obtain the benefits of pooled investment (scale and expertise of the manager) whilst minimising costs that result from investing indirectly (and hence for US investors, check the box).

70) In many ways the position of such investors is akin to be being a minority shareholder that is "party to a commercially standard ... investor agreement that does not have material impact on the ability of a holder to exercise ownership or control over its equity of voting interest" (OECD Final Report on BEPS2 at section 374). The difference is that the investors have delegated, collectively, the underlying management to a fund manager: and this triggers "acting together".

71) This provision means that hybrid rules will generally apply to all funds with US investors, because it means that each investor will have a minimum 25% investment and the structure, for US reasons, will generally always involve check-the-box elections. For many, the provisions around dual inclusion income should mean that there is little impact in practice – but the application of the rules is not straightforward, and results in additional administrative costs and possible timing issues for the fund manager (and difficulties, as well as possible tax costs, depending on the evidence that the fund manager can obtain to support any "reasonable supposing").

72) A change to the rules that dis-applied automatic "acting together-ness" by otherwise unrelated portfolio investors within a widely held collective investment vehicle would be helpful in maintaining the UK's attractiveness as a location for investment. This may not reflect the OECD specific recommendation, but we would note that significant work on CIVs has been carried out since then (both within the OECD but also within the UK in the context of the recent extension of CGT), improving tax authority understanding of their structures and objectives. As a result, it may be possible now to move away from a "blanket approach" (as now) to something more nuanced – and with a greater ability to craft realistic and reasonable conditions.

73) In this context, we note the specific exclusion in s259ND(8) where a number of funds with the same manager co-invest (where "acting together" is tested by reference the reality of the position). Our ask is basically that the same approach be taken in relation to portfolio investors in widely held funds (save that the requirement of s259ND(8)I would not be apt in this situation: we would of course be happy to work with HMRC to identify other means of minimising any risk to the Exchequer from this change).

Exempt investors in hybrid entities

Q12. Do you agree that a change of the type described above would be beneficial?

74) We welcome HMRC's willingness to consider an amendment in relation to exempt investors to address the issue outlined in paragraph 4.1 of the Consultation Document.

75) We agree that a change would be beneficial. This is because many investors in real estate funds are institutional investors, of which a significant proportion are tax exempt entities: the type of change being proposed by HMRC will therefore ensure that the application of the hybrids rules to funds is properly targeted to where there is a causal connection between the hybridity and the mismatch.

76) The Consultation Document suggests that any change would apply where the tax-exempt entity invests in, and makes a payment to, a hybrid entity (and so would be limited to Chapter 7).However, any change to address the position of exempt investors should equally apply to Chapter 3.

Q13. What entities other than pension funds might qualify for the exemption (whether implemented via principles-based definition or lists)?

77) In addition to pension funds, other exempt investors would include sovereign immune entities, charities and life companies.

78) Notwithstanding the specific examples given above, we do not recommend that the legislative solution to this issue contain a specific list of investors that are "acceptable" tax exempts (a white list) or not acceptable (a black list). In addition to the risk of missing out entities that should be provided for, there is a risk that a list could be out of date – and even if HMRC have the right to amend by way of statutory instrument, the required legislative process would delay any update (plus the time cost in persuading HMRC that an SI update is needed). (Although legislative lists have been used within the REIT provisions (for qualifying investors), SSE (for qualifying institutional investors) and Schedule 5AAA TCGA, we are aware of past experience of stakeholders who have suggested changes which, if agreed, take time to be made) and hence would prefer a more flexible approach here).

79) If instead examples of "acceptable" entities are included in guidance, updating guidance should in practice involve a shorter lead in, plus it would keep open the possibility of a clearance as to a particular entity in the meantime (which would not be possible with a prescribed legislative list).

80) The Consultation Document sets out three potential options for making this amendment. On the basis of our comments above, we are not in favour of options (a) (white list) or (b) blanket exemption with black list).

81) The third option, a principles based approach, risks adding complexity and uncertainty, particularly given the possibility of differences in interpretation of principles between HMRC and taxpayers. We would therefore recommend a hybrid approach is taken, combining option I with (a). This would involve setting out a principles based definition of an "acceptable" tax exempt entity, with the legislation then setting out (by way of an "including" list) specific examples of say two or three entities that would satisfy those principles. This provides certainty for the most clear-cut and common tax exempt investors.

82) Guidance could then supplement the legislation: perhaps explaining how the specific examples satisfy the principles based criteria, and then commenting on one or two other examples (both ones that would be "acceptable" and ones that would not be, again explaining why).

83) In terms of the principles to apply, the key principle would be that the investor is exempt on the relevant item of "ordinary income" within its own jurisdiction of residence [because of its status] (as opposed to being generally exempt on all income and gains). The fact that its own jurisdiction confers an exemption on the income in question should be sufficient indicator that the hybridity of the payee was not material to any mismatch (i.e. there would have been no tax in any event). The reason for focusing on the particular type of income can best be illustrated by reference to charities (using the UK rules as an example). A UK charity is exempt on its investment income and gains, and income from charitable activities – but it is possible that a charity may carry on a trading activity directly, and if so, if that trading activity is non-primary purpose, its trading income would not be exempt (s478 CTA 2010). The fact that a part of the charity's income is taxable should not prevent it from being treated as an "acceptable" tax exempt in the context of income received as part of its (exempt) charitable activities.

Q14. What evidential requirements would be necessary to back up a taxpayer's contention that a new exemption of this type was available? Would the "reasonable to suppose" test suffice, or would it be appropriate to require something different?

84) We consider that the "reasonable to suppose" test should apply. This ensures consistency with the position on other aspects of the rules and the rationale for this approach as set out in INTM550640 equally applies in this context.

85) As a result, the fund manager would determine the evidence that they considered they needed to make a reasonable supposition of the position, taking account of information that they may already have access to through KYC and CRS reporting requirements – and, going forward, make any relevant arrangements with investors for anything additional that they consider they require. This is in keeping with the self-assessment process under which the application of Part 6A TIOPA is assessed, and reflects the fact that, given the different types of exemption, there can be no "one size fits all" approach to evidence of status.

Impacts

Q15. Having considered the areas discussed, do you think if changes were introduced they would have any impact on administrative burdens and costs? If so, please provide details, including any one-off and on-going costs.

86) The changes referenced in the Consultation Document to the "acting together" rules and the position of exempt investors, if implemented correctly, would simplify compliance with the rules by providing more certainty as to the position for taxpayers. This would reduce on-going costs of affected UK companies within funds. It should also have the impact of taking certain arrangements out-with the hybrid rules, which should have an impact on corporation tax payable (as deductions for expenses would no longer be deferred or disallowed under the hybrid rules – although where the cost was a financing cost, may still be restricted under the corporate interest restriction or other UK rules in any event).

87) There would be an initial one-off cost due to the need for companies and advisers to familiarise themselves with the new rules, and make any necessary changes to their internal processes (for example, identifying the extent to which they have exempt investors).

88) In relation to the changes to the double deduction provisions and s259ID, the impact will be dependent on what is proposed. Limited technical changes may add to complexity and add little benefit in practice. A more ambitious change is likely to be of assistance to new funds/fund managers only: for existing arrangements, if restructuring has been carried out to mitigate the impact of the rules already, a cost/benefit analysis may mean that it is commercially sensible to stay "as is" rather than restructure again.

89) However, if the government is willing to consider broader changes to address the issues highlighted in the Appendix to this note (and as referenced in our response to HM Treasury's consultation on the Tax treatment of asset-holding companies), we consider that this would enhance the attractiveness of the UK to funds – and would helpfully build on other recent developments in the funds area (such as the engagement with the funds industry in relation to the extension of CGT to non-resident owners of land and the introduction of QII SSE in 2017).

Hybrid and other mismatches

Q16. Having considered the areas discussed, do you think if changes were introduced they would have any additional impact on small and micro businesses, not already covered? If so, please provide details, including any one-off and on-going costs.

90) No comment. However, we note that, unlike CIR and CILR/CCLR, the hybrid rules do not include any form of "de minimis". As a result, a small business could be as impacted by these provisions as a larger company, and so anything that simplifies the rules should benefit small businesses (and hopefully reduce compliance costs).

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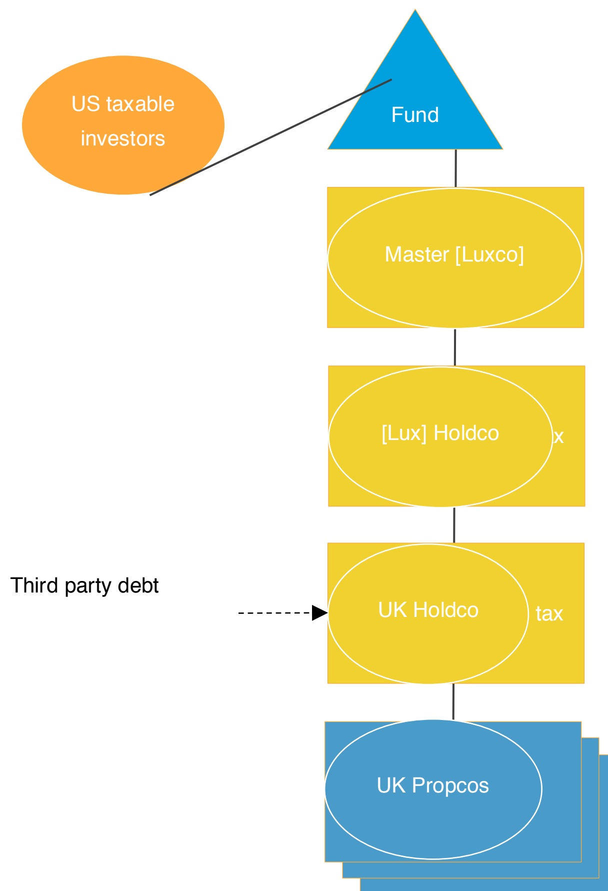
Appendix 2: Examples in relation to dual inclusion income

1. All these examples concern a fund established to invest in UK real estate. The Fund is set up as a partnership (and so is transparent for tax purposes) and so structures its investments using single purpose vehicles. As the Fund has a number of US investors, it makes check-the-box elections in relation to those vehicles to minimise any tax mismatches for investors between (a) investing in the Fund and (b) investing directly.

Mezzanine Debt

2. Issue arises because deductions for interest on the mezzanine debt arise in a different company (Mezzco) to that which holds the real estate (asset holding company or AHC).



3. We note that his has similarities to the example: no dual inclusion income at INTM557200, although the INTM example is based on companies within the same control group.

4. The Fund's investments include a UK property which is owned by a single purpose company (AHC), with AHC owned by a single purpose holding company (Mezzco).

5. The acquisition of the property was funded by a mix of third party debt (senior (bank) lending and mezzanine finance) and equity (which may include shareholder loans). AHC is the borrower under the senior loan. Mezzco is the borrower under the mezzanine finance: this is necessary to achieve structural subordination (a requirement of the senior lenders). Mezzco on-lends the proceeds of the mezzanine finance to AHC although it may as an alternative use it to make an equity subscription).

6. For UK corporation tax purposes, AHC brings into account rental income from the property and is entitled to a deduction for (i) interest on the senior loan and (ii) interest paid on the loan to Mezzco (if there is an on-loan).

7. If Mezzco is UK tax resident, it will bring into account interest income on the loan to AHC and is entitled to a deduction for interest on the mezzanine finance: its corporation tax profit is the "turn" it makes on its lending activities.

8. (If Mezzco instead uses the mezzanine finance to fund an equity subscription in AHC (rather than make a loan), then it will bring into account dividends paid to it by AHC and is entitled to a deduction for interest on the mezzanine finance: as dividends should be exempt from corporation tax, it will have a non-trading deficit, which it can surrender to AHC by way of group relief.)

9. For US federal tax purposes, check-the-box elections will have been made in relation to each of AHC and Mezzco. Fund investors will therefore bring into account AHC's rental income, interest payable on the senior loan by AHC and interest payable on the mezzanine finance by Mezzco. Any on-loan from Mezzco to AHC will be disregarded. As a result, investors are broadly placed in the same position they would have been had they invested directly.

10. Applying Chapter 9 of Part 6A TIOPA to Mezzco:

    (a) Mezzco is a hybrid entity

    (b) as it is "reasonable to suppose" that interest payable by it under the mezzanine finance is deductible both by it and any Fund investor, that interest is a double deduction amount (Condition A is met)

    (c) Mezzco is within the charge to corporation tax (Condition B is met)

    (d) Condition C is met given each investor will be regarded as "acting together" with other investors given s259ND(7)(d) TIOPA.

11. In this situation, there is no "dual-inclusion income" as far as Mezzco is concerned. This is because, for Fund investors, interest on the mezzanine finance is offset against rental income (given the effect of the check-the-box election, Mezzco and AHC are effectively consolidated as both are disregarded for US tax purposes) but for Holdco the interest is offset against the income that arises to it from Propco (interest on any on-loan or dividends): and "dual inclusion income" is defined by reference to the "ordinary income" of the company that has the deduction (s259ID(8)).

12. Because the UK applies a "solus"/single entity tax system, the fact that the underlying source of Mezzco's income is AHC's rental receipts is irrelevant (as AHC is a single purpose entity).

13. This remains the case where Mezzco uses the mezzanine finance to fund an equity subscription and group relieves its non-trading deficit to AHC (with the effect that, for UK tax purposes, Mezzco's deduction directly offsets AHC's rental income).

14. The UK solus system of taxation therefore means that Mezzco's income cannot be ordinary income of an investor in the Fund because of the effect of "check-the-box" and so there is no dual inclusion income. As a result, the entirety of the deduction for interest on the mezzanine finance is disallowed.

15. In contrast, had the mezzanine finance been lent directly to AHC, then there would be dual inclusion income (the rent payable to AHC), and so Chapter 9's impact should be negligible in practice.

16. Given that the reason for placement of the mezzanine finance at Mezzco is commercial (linked to lender requirements), it seems inequitable that there should be such a difference in treatment of what, in economic substance, is the same arrangement - which, in both cases, is structured to enable interest on the mezzanine finance to be offset against Mezzco's rental income (whether through an on-loan or group relief). If the UK had a consolidation system for corporation tax, the Mezzco and AHC's income and expenses would be pooled (which, in a more limited way, is what group relief achieves), and the net aggregate position would be dual inclusion income for the consolidated group and the US investor (through the check-the-box election).

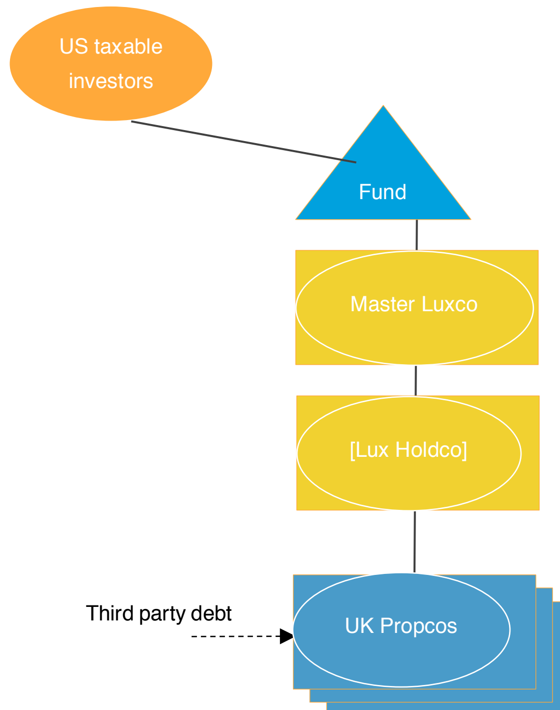
17. We ask for consideration to be given to amending the definition of dual inclusion income to allow account to be taken of both AHC and Mezzco (combined) in this situation: whether by a form of deemed consolidation of their income and expenses or by allowing Holdco's income to be traced to its underlying source (AHC's rental income).

18. In this context, we note that the public infrastructure exemption within the corporate interest restriction (Chapter 8 of Part 10 TIOPA) provides for a form of "tracing" within the definition of "qualifying infrastructure company" (a company can be a QIC if it itself carries on a qualifying property business or if its activities are limited to making on-loans to/equity investments in a company that is itself carrying on a qualifying property business): see s433(2)(5) and also the group election provisions in s435 TIOPA) which, in part, was in recognition of common holding structures for real estate investment taking account of mezzanine finance arrangements).

19. Another possibility of addressing this issue would be to amend the "acting together" rules so that portfolio investors within a fund structure are not seen as related parties simply by virtue of co-investment (and therefore sharing the same fund manager). This should mean Condition C should not be met (see here comments in response to questions 8 to 11). However, we note that, given the highly technical and prescriptive nature of the rules, and their purpose (implementing an OECD recommendation) the government may prefer to target any amendments at the specific issue around "dual-inclusion income".

Development Finance

20. Issue arises from timing mismatches where asset holding company (AHC) raises development finance (so deductions arise in periods in which the AHC does not recognise any income for tax purposes).



21. The Fund's investments include a UK property which is owned by a single purpose company (AHC). The property is in need of redevelopment: so AHC takes out development financing. The redevelopment is expected to take two to three years, and AHC will then let out the building (this is a develop to hold, not a develop to sell, model).

22. For UK corporation tax purposes, during the redevelopment period, AHC will not bring into account any income. Interest expense will accrue and give rise to non-trading deficits, which will be carried forward to offset future rental income (subject to CILR).

23. For US federal tax purposes, a check-the-box election will have been made in relation to AHC. Fund investors will therefore bring into account interest payable on the development loan.

24. Applying Chapter 9 of Part 6A TIOPA to AHC:

    (a) AHC is a hybrid entity

    (b) as it is "reasonable to suppose" that interest payable by it under the development loan is deductible both by it and any Fund investor, that interest is a double deduction amount (Condition A is met)

    (c) AHC is within the charge to corporation tax (Condition B is met)

(d) Condition C is met given each investor will be regarded as "acting together" with other investors given s259ND(7)(d) TIOPA.

25. In this situation, there is no "dual-inclusion income" during the development period - because there is no "ordinary income" in AHC until the property is let.

26. For the investor, it may be able to get relief for interest on the development loan against other income arising to it during the development period. We acknowledge that the offset of a double deduction against other income is the target of the OECD measures under this limb of the rules (section 181 of the OECD Final Report).

27. However, in many cases, the Fund will have other investments (in addition to AHC), and so for investors, that "other income" is likely to include rental income from other Fund investments (arising to the investor given the making of check-the-box elections by the Fund).

28. For the investor, the fund is a single investment (and it measures its profit/loss against the performance of the fund as a whole, and not individual investments). The effect of check-the-box elections made by the fund is that the investor recognises (directly) all income and expenses of the fund's investments for US tax purposes. It would therefore, in any given taxable period, "pool" those results so that its US tax position is based on the net result.

29. This is the context in which the investor obtains relief for AHC's interest expense before AHC is able to do so (against other income) - with the consequence that, in later years (ignoring Chapter 9) the investor recognises a greater taxable profit than AHC (i.e. the position reverses out among fund investments as a whole). This is because, as and when the property is let out, it will have a different tax profile to AHC on the resulting "dual inclusion income" from AHC's property (as AHC will offset current year interest and carry forward non-trading deficits (subject to Chapter 9 and CILR), and the investor will be offsetting current year interest only - subject to it having other reliefs available).

30. The issue is therefore basically a timing one: the investor obtains relief in the "early" years, but has greater net taxable income than AHC in later years. Although there is a hybrid entity, there is no tax arbitrage as such.

31. However, under the hybrid rules, if the investor obtains relief for interest on the development loan during the redevelopment period, then there is an "illegitimate overseas deduction" in each relevant accounting period which limits AHC's ability to obtain relief for its interest expense - even though in the later periods it has dual inclusion income. As a result, the hybrid rules create a permanent disallowance within AHC, even though there should be full recognition of taxable income in both AHC and the investor: creating asymmetry in tax outcome, and failing to reflect the economic substance.

32. We ask for consideration to be given to amending the definition of dual inclusion income to allow account to be taken of the economic reality of this situation: so that the meaning of "dual inclusion income" recognises the commercial reality of fund investment, with AHC able to offset its deduction against the "later" dual inclusion income that will be brought into account by it and the investor. It does not seem equitable to impose an absolute disallowance in response to an issue that is one of timing (and note here sections 185 and 196 of the OECD Final Report on BEPS2). Effectively, this would mean that a disallowed amount (under Part 6A) can be carried forward and relieved in a later period when there is dual inclusion income.

33. Plus, although some investors may have a choice as to when they recognise deductions (such that an investor could opt out of any illegitimate overseas deduction and instead wait to claim the deduction until AHC recognises income - assuming its jurisdiction allows it to do so), there may be situations where

this is not possible. We note here section 213 of the OECD Final Report on BEPS 2, but the position is ultimately no different to that described above as the timing issues will reverse out – i.e. with the income being taxable for the investor without the deduction in a future period.

34. We acknowledge that if there is a change in investor, then the profile may be different: but many real estate funds are closed ended, with investors committed for the entirety of the fund's life (and the rules could be limited to such situations).

35. Again, another possibility of addressing this issue would be to amend the "acting together" rules so that portfolio investors within a fund structure are not seen as related parties simply by virtue of co-investment (and therefore sharing the same fund manager). This should mean Condition C should not be met (see here comments in response to questions 8 to 11) But given that this issue arises from the meanings of "dual inclusion income" and "illegitimate overseas deduction", an amendment targeted at these provisions seems more appropriate.

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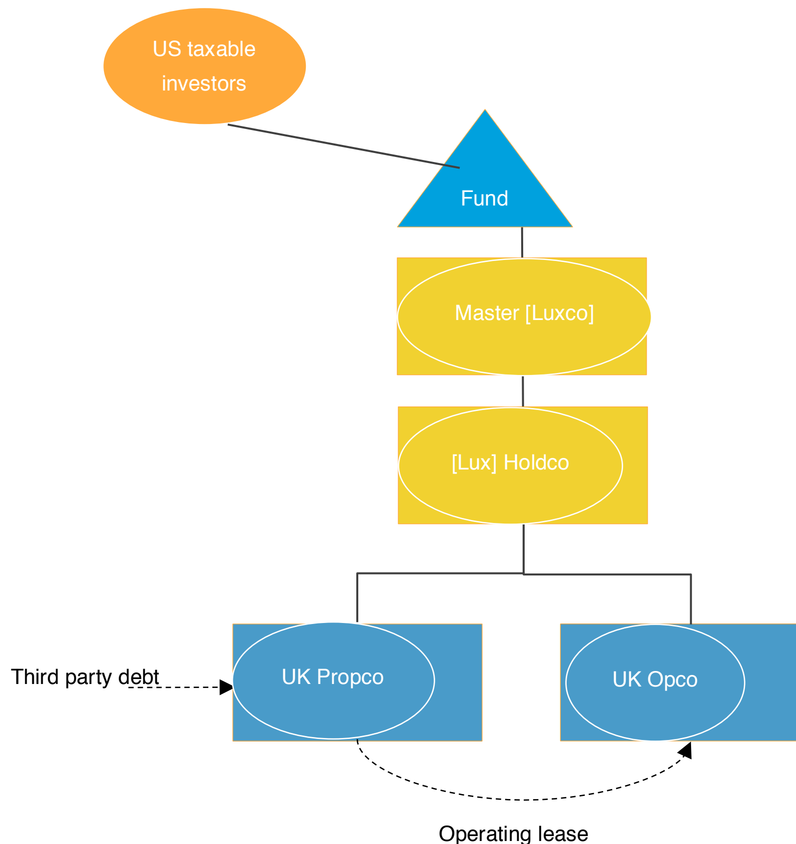
Opco/Propo structures

36. The issue arises from different classification of intra-group rental income in investor and AHC jurisdiction.



37. The Fund's investments include a UK property-rich business (e.g. a care home). The Fund has structured the holding of this investment through a Propco/Opco structure: Propco acquires the UK properties from Opco and leases them to Opco, which carries on the trading activities - and, in relation to a care home business, will receive "fees" and/or rents from third party customers. Propco funds the acquisition of the properties by bank debt; Opco may additionally borrow through working capital facilities.

38. For UK corporation tax purposes, Propco brings into account rental income from Opco and is entitled to a deduction for its interest expense under the bank loan.

39. Opco brings into account its trading income and is entitled to a deduction for its rental payments to Propco.

40. Economically, Opco is funding the servicing of the bank loan through its rental payments - the sale and leaseback of the properties is in substance a financing.

41. For US federal tax purposes, a check-the-box election will have been made in relation to each of Propco and Opco. The effect is that payments as between Propco and Opco are disregarded (as effectively

payments to oneself) with investors recognising (a) third party interest expense and (b) third party income from customers of Opco.

42. Applying Chapter 9 of Part 6A TIOPA to Propco:

(a) Propco is a hybrid entity

(b) as it is "reasonable to suppose" that interest payable by it under the bank loan is deductible both by it and any Fund investor, that interest is a double deduction amount (Condition A is met)

(c) Propco is within the charge to corporation tax (Condition B is met)

(d) Condition C is met given each investor will be regarded as "acting together" with other investors given s259ND(7)(d) TIOPA.

43. In this situation, there is no "dual-inclusion income" because, for Fund investors, the income that they recognise payable by a third party (customers of Opco) whereas, for Propco, its income against which the interest deduction is sought is under its third party lease to Opco. This different characterisation for US tax purposes means that, it is not "ordinary income" of both hybrid and investor within s259IC.

44. As a result, the entirety of the deduction for interest on the bank loan is disallowed. This is notwithstanding that income is taxed both in Propco and in the US.

45. We ask for consideration to be given to amending the definition of dual inclusion income to allow Propco to access relief for its interest costs in this situation. We note here that, if the UK had a form of fiscal unity regime or allowed consolidation for tax purposes, then Propco and Opco would report income "together" and as a result, subject to the detail of any such regime, the hybrids issue should not arise (as the Propco/Opco payments should be disregarded so interest would be offset against Opco's third party income): the issue here, as with the example given in relation to mezzanine finance. is that the UK's solus entity corporation tax system results in separation of income and expense, even if (in substance) they should be considered together.