INREV response to HM Treasury's consultation on tax treatment of asset holding companies in alternative fund structures

INREV

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About INREV: the voice of the European non-listed real estate investment industry

INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. We provide guidance, research and information related to the development and harmonisation of professional standards, reporting guidelines and corporate governance within the non-listed property funds industry across Europe.

INREV currently has 458 members. Our member base includes institutional investors from around the globe including pension funds, insurance companies and sovereign wealth funds, as well as investment banks, fund managers, fund of funds managers and advisors representing all facets of investing into non-listed real estate vehicles in the UK and the rest of Europe. Our fund manager members manage more than 500 non-listed real estate investment funds, as well as joint ventures, club deals and separate accounts for institutional investors.

Introduction

INREV welcomes the opportunity to contribute to the dialogue between the government, the regulator, and industry following the work of the Asset Management Taskforce, which was introduced to improve the government's understanding of intermediate entities within fund structures – generally referred to as asset holding companies (AHCs) - the fund structures in which they are commonly used, the commercial drivers of their location and the fiscal and economic benefits that they bring to the jurisdiction in which they are located. In particular, we hope by our submission to contribute constructively to the discussion of the barriers that the UK corporation tax system might be creating for the establishment of these companies in the UK, the merits of taking steps to remove those barriers, and the different options that might exist for doing so.

We therefore respectfully submit the following comments to the questions raised in the consultation.

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

As outlined in the Consultation Document, there are a number of commercial reasons for using AHCs between a fund (or other investment vehicle) and its underlying investments. A fund may own multiple different AHCs performing different functions. Some AHCs may be 'Special Purpose Vehicles' ('SPVs') to hold specific investments while others may hold some or all of a fund's SPVs and investments.

Other benefits of using AHCs include:

Ring fence Liabilities: limit the liability of the fund and investors due to the limited liability of the corporate form of the AHC, as well as ring fencing of liability across different assets.

Facilitate joint ventures and co-investments: allowing joint venture partners and co-investors to invest in specific assets through an AHC directly rather than in all assets of the fund.

Consolidation: consolidate management and/or investment management agreements as well as for meeting substance requirements.

Calculation of a single Net Asset Value: a single AHC consolidating various real estate investments offers obvious administrative advantages in the managing of assets within a single structure. Different real estate projects can be integrated into a top level AHC which is the basis for calculating a single reportable Net Asset Value (NAV) rather than numerous valuations for different real estate projects. This has the benefit for calculating value for the fund structure as a whole.

Financing Covenants: this enables a fund to obtain financing in different ways, for example, specific financing arrangements for certain investment(s) rather than all the fund assets.

Administrative ease: AHCs offer administrative ease of being able to be transacted without the need to dispose of the underlying asset. This includes not needing to transfer existing contractual arrangements and retain the ring fencing within the AHC.

The tax considerations referred to in the Consultation Document are also significant. The funds are often in the form of tax transparent or tax-exempt vehicles. There can be administrative challenges for them to access the benefits of double tax treaties, some investors will be ineligible and by owning a small interest via a fund will restrict the access to the most beneficial double tax treaty provisions. In addition, the fund investors may change over time depending on the type of fund, i.e., open or closed ended funds.

From the perspective of the investors, looking through to the underlying investments can make their own tax filing obligations highly complex. Interposing an AHC that is a taxpayer in its own right can often address these issues.

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

AHCs are prevalent in other funds or pooled investment structures. As the Consultation Document indicates, the most common of these sectors are Private Equity, Credit and Real Estate. Infrastructure is another asset class that uses AHCs. In addition, AHCs are also commonly used in joint ventures due to the size of investments and investment restrictions contained in fund documentation forcing infrastructure funds to invest via joint ventures

AHCs can be used in closed-ended as well as open-ended funds or a hybrid of the two. Examples of pooled investment structures which use AHCs include:

- Authorised Contractual Schemes (ACSs);
- Luxembourg limited partnership (société en commandite simple or SCS) and the special limited partnership (société en commandite spéciale or SCSp), reserved alternative investment fund (RAIF); and
- Irish Common Contractual Funds (CCFs).

We note in this regard that we support the proposal submitted by the Association of Real Estate Funds for a Professional Investor Fund ('PIF') (https://www.aref.org.uk/resource/new-fund-vehicle-proposed.html) in the form of an unauthorised closed ended or hybrid tax transparent entity. The PIF would make use of AHCs for the same reasons.

We consider the diagram presented within paragraph 2.9 of the Consultation useful, but it represents only one example of how AHCs are used within investment structures. AHCs are used both vertically and horizontally within real estate structures. A vertical AHC structure could be used to layer debt obligations adjusted to reflect the seniority of the legal commitments while AHCs may be spread horizontally for utilisation of liability ring fencing for individual projects.

This illustrates that AHCs can perform single or multiple functions within a structure. We suggest that any solution considered in response to this consultation is flexible to allow existing and future investment structures to benefit from the changes. The Consultation Document was framed in the Budget as being part of a broader consultation on the UK funds environment. The solutions - considered in response to this consultation - should apply to new fund regimes or vehicles for holding alternative fund assets including the PIF if the necessary legislation is adopted.

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

A competitive AHC regime will encourage alternative funds to be established and operated in the UK. The AHC regime would provide opportunity to those investment managers that have significant UK operations and have had to establish and operate investment holding structures outside the UK on account of the absence of a competitive UK regime.

Important economic and fiscal benefits are likely to result from AHCs being established in the UK. The most recent INREV-EPRA Real Estate in the Real Economy Report highlights:

- Additional direct employment in the investment, fund and portfolio management industries, which are small but disproportionately high value-added activities, ultimately contributes 6.5 times more economic stimulation to the economy per worker than the overall European average value-added per worker;
- Employment in transactions, management and construction are directly dependent on the investment, fund and portfolio management industries. Indirectly, they contribute a value added multiplier of 2.96 to employment across the construction supply chain, business and consumer services, professional, scientific & technical services, and public and private administration & support services; and
- The benefits of this are manifest in improved standards of living and attainment, and the impact on consumption induces a further jobs multiplier of 0.8.indirectly. (https://www.inrev.org/system/files/2019-04/INREV-EPRA-Real-Estate-Real_Economy_2018_Report.pdf)

Direct Fiscal Benefits

As the consultation acknowledges, the benefits can be broadly considered as either direct revenue for the Exchequer or indirect economic advantages derived from activities surrounding the AHCs themselves. The economic and indirect fiscal benefits of UK AHCs are likely to be greater than direct fiscal benefits.

Economic and indirect fiscal Benefits

Ancillary Services: The servicing of real estate held by AHCs is significant and requires a number of support sectors. These include auditors, administrators and legal firms involved in the establishment and operations of such vehicles. Other frequently used fund jurisdictions have seen demonstratable benefits in having these industries built around the AHCs in question.

Management of Fund Structures utilising AHCs*:* The UK operates as one of the global hubs for fund management. As the Consultation Document states, the UK asset management sector is the largest in Europe and the second largest globally. The UK regulatory and tax environment must evolve to remain competitive by being responsive to investor preferences.

If the AHC can be located in the UK, this strengthens the case for the fund that owns it to also be based in the UK, to meet tax obligations. The changes to the international tax environment as a result of the OECD Base Erosion and Profit Shifting (BEPS) Action Plans are discussed further in the response to Question 6 below.

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

As an industry organisation focusing on the real estate funds sector, our focus is on real estate. However, we believe that infrastructure investments should be taken into account and has many similarities to real estate as an asset class. Many investment managers invest across real assets (real estate and infrastructure) as a combined business and many investors consider a large share of social infrastructure to fall within their real estate allocation.

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

For the real estate sector, the following are the key challenges in setting up UK AHCs. Many of these are also relevant for other asset classes including infrastructure.

Interest Withholding Tax

The absence of dividend withholding tax is seen as a significant competitive advantage for certain types of investment. The imposition of withholding on interest, in contrast to other popular fund and AHC domiciles, puts the UK at a considerable competitive disadvantage from a tax drag and a promotional perspective. AHC jurisdictions such as the Netherlands and Luxembourg do not apply interest withholding.

Subject to any exemptions, a payer of interest is obliged to apply 20% withholding tax on UK source interest payments to a non-UK resident lender. While there are exemptions and the possibility of treaty reliefs depending on the residence of the recipient, this remains one of the two largest stumbling blocks for the use and marketing the use of AHCs within the UK.

Substantial Shareholding Exemption (SSE)

One key challenge for real estate funds is SSE and the requirement for the company being disposed of to be a trading company or a company in a trading group. This means that where the fund does not have Qualifying Institutional Investors, the SSE will not apply to disposals of shares in companies carrying out real estate investment activities. In contrast, participation exemption regimes in other countries do not generally distinguish between trading and investment companies and can therefore be more widely applied.

Hybrid mismatch rules

The UK anti-hybrid rules are another key challenge for funds due to the way investment funds and AHCs are viewed across different investor jurisdictions.

The complexity of UK rules means that investment managers need to spend considerable resources to assess the impact of the rules and their interaction with other parts of the UK tax legislation to ascertain any limitation on tax deductibility of interest under the corporate interest restriction rules.

EU related issues

UK's exit from the EU means loss of access to the Parent-Subsidiary Directive and the Interest and Royalties Directive (collectively the 'Directives') for the UK after the transitional period. Access to these Directives would have offered UK AHCs an automatic EU withholding tax relief without dealing with double tax treaties.

With this access falling away, any relevant Double Tax Treaty offering a rate higher than those set out under the Directives, would put UK AHCs in a less attractive position for holding pan-European real estate assets.

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

There have been a number of international tax measures including OECD's BEPS Action 6, ATAD and minimum substance requirements on low tax jurisdictions, all of which have increased the focus on local substance to be able to access treaty benefits and other wider EU tax benefits.

These international initiatives together with the changing regulatory landscape have led to some businesses reviewing the design and location of their fund structures. This has meant that rather than seeing AHCs relocate back to the UK, further investment has been made in other jurisdictions to increase local substance by UK based fund managers to ensure they retain footprint and continue to do business in the EU post Brexit.

It is also worth highlighting that the investment industry is becoming increasingly wary of basing operations, and to a lesser extent capital, within jurisdictions which are perceived to be tax havens. The EU's tax haven 'blacklist', has had an impact on operating models as well as investor preferences for 'good' locations.

The increased public scrutiny and investor preferences, particularly non-European investors and institutional investors such as pension funds, could work in favour of UK's position as a suitable alternative funds and AHC location.

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

The UK company law requirement to have distributable reserves for paying dividends is a significant non-tax barrier in setting up UK AHCs. In contrast, Jersey and Guernsey offer more flexible solvency tests making cash repatriation much easier. Subject to introduction of safeguards, a similar provision could be considered in the UK.

Lack of choice of UK fund vehicles is another key barrier to AHCs being located in the UK. In this regard, we:

- welcome the UK fund regime review and the review of VAT in fund management; and
- support the PIF initiative.

Jurisdictions such as Jersey, Guernsey, Ireland and Luxembourg offer a wider choice of fund vehicles. They have built up their reputations over a number of years and considerable industry investment. UK's exit from the EU offers an opportunity for the UK to redefine its tax and regulatory framework thereby making it an attractive fund location.

<u>Question 8</u>: How could the challenges identified under Question 4 best be overcome?

We have set out below some of the solutions that will help address the barriers that currently exist for AHCs being established and operated in the UK:

Interest withholding tax
Introduce a specific exemption aimed at AHCs/funds or through removal of interest withholding for all payments except those made to investors located in a black listed jurisdiction and/or received by entities that are owned by investors who are located in a jurisdiction with which the UK does not a comprehensive double tax treaty. A specific exemption, although helpful, could be complicated to apply in practice when compared to easier and more certain exemptions available in other popular fund jurisdictions.

Substantial Shareholding Exemption (SSE)
Simplify the SSE rules much like participation exemption regimes available outside the UK and, in particular, amend the trading company restrictions on investee groups allowing real estate fund structures to benefit from the exemption. The changes could carve out entities that are UK property rich to ensure that UK does not lose the taxing right for UK property and to deal with avoidance.

Hybrid mismatch rules
Consider the interaction between how any future UK AHC regime would interact with the UK anti-hybrid rules, which are under separate consultation. For a UK AHC to be attractive, it will be necessary for the UK anti-hybrid rules to be aligned with ATAD II such that they are only relevant when the hybridity is the cause of non-inclusion. The acting together rules should also be widened so that investors are not treated as acting together by virtue of being in partnership.

Review of other aspects of the UK fund regime including VAT
Ensure that the VAT treatment of onshore AHCs and relevant fund vehicles is competitive to the VAT position of offshore vehicles. We welcome the government's review of VAT charged on fund management fees.

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

A new specific regime aimed at AHCs will have the benefit of flexibility to cater to different asset classes ensuring wider applicability. The new regime will also be impactful as a promotion tool for UK as a holding company location.

The eligibility for the regime, however, will need to be carefully drafted to ensure that the regime applies to a wide range of structures and offers current and future certainty that investment managers seek while making location decisions for these structures.

A clear and well considered definition of alternative funds and AHCs will need to be introduced. Some of the current definitions such as the Financial Services and Markets Act 2000 definition of collective investment scheme could provide a good base but will be required to be amended to accommodate joint ventures and co-investments.

We remain at your disposal should you wish to discuss the above in more detail.

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