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Asset Holding Companies Consultation
Corporate Tax Team
HM Treasury
1 Horse Guards Road
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For the attention of Sam Deaner

25 August 2020

Dear Sam,

Response to the Consultation on the Tax Treatment of Asset Holding Companies in Alternative Fund Structures

The Association of Real Estate Funds[1] ("AREF") welcomes the opportunity to respond to the HM Treasury consultation on the tax treatment of asset holding companies (AHC) in alternative fund structures ("the Consultation").

We note that the Consultation is part of the Government's review of the UK fund regime announced at Spring Budget 2020 which has been widely welcomed by the investment management industry. The Consultation itself is aimed at alternative fund structures, including inter alia real estate structures. Our response is focussed on areas and issues specific to the real estate fund industry, some of which may indeed be common with other alternative funds.

Before we address the Consultation questions in detail, we would like to highlight that holding structures are typically, though not always, aligned with the location of fund vehicles. This is evident from the success of some of the popular European fund jurisdictions such as Ireland and Luxembourg. Therefore, while a review of the asset holding company taxation is important and

[1] The Association of Real Estate Funds represents the UK real estate funds industry and has 67 member funds with a collective net asset value of more than £70 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the MSCI/AREF UK Quarterly Property Funds Index and the MSCI/AREF Property Fund Vision Handbook.

relevant, its success will be very much dependent on the wider UK fund regime review and to what extent the UK can establish itself as a location for alternative funds.

Overwhelming feedback from our members suggests that a competitive tax regime accompanied by suitable companies' law rules and regulatory regime with well-defined and complementary features is required for the success of UK AHCs.

In order for the tax regime to be competitive and successful, it needs to not only offer a tax outcome that is internationally competitive and comparable to other popular fund locations, but also be flexible, simple to understand and apply, offering businesses tax certainty at proportionate administrative and compliance costs. We think that in an AHC context, this can be achieved through amendments to the existing regime with an aim to remove barriers that currently deter holding companies from being set up in the UK. We believe that this would be easier to achieve than a new regime and also provide more flexibility across a range of structures than a special regime with a strict eligibility criterion. In this regard, amendment and simplification of the Substantial Shareholding Regime (SSE) and removal of interest withholding tax are two of the important areas of consideration for the real estate funds industry.

To the extent that a new specific regime is deemed prudent, workable and addresses both the SSE and interest withholding issues prior to implementation AREF would be supportive of a parallel approach through further consultative engagement.

We have sought to respond to each of the questions raised in the Consultation below:

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?

AHCs that include intermediate holding companies as well as Special Purpose Vehicles (SPVs) are commonly used within alternative fund structures as a pooling vehicle for different types of investors and/or also for holding and ring-fencing different investments. There are a number of commercial, regulatory, legal, tax and administrative benefits of using AHCs as detailed below:

Ring-fence Liabilities: One of the key commercial benefits of using AHCs is to limit the liability of the fund and investors due to the limited liability the corporate form of the AHC provides. Importantly also AHCs allow ring fencing of liability across different assets.

Facilitate Joint Ventures and Co-investments: AHCs are critical in allowing real estate projects to be structured in ways which suit the needs of the underlying investors allowing joint venture partners and co-investors to invest in specific assets through an AHC directly rather than in all assets of the fund. Conversely, co-investors and joint venture partners do not have any recourse to other assets held outside that AHC.

Consolidation: AHCs can also be used to consolidate management and / or investment management agreements. Consolidating substance or administrative presence in the AHC also helps ensure that increasing substance requirements are met.

Calculation of a Single Net Asset Value: The use of a single AHC consolidating various real estate investments offers a number of obvious administrative advantages in the managing of assets within a single structure. Within a real estate context, many different property projects can be integrated into a top level AHC which then allows for calculation of a single reportable Net Asset Value (NAV) rather than multiple valuations for various real estate projects. This has administrative advantages for calculating the value for the fund structure as a whole, but can also offer benefits in allowing for cash to be paid more easily through the investment chain to investors.

Financing and Banking Covenants: AHCs allow a fund to access financing in a range of different ways, for example, specific financing arrangements for certain investment(s) rather than all assets of the fund and rendering lender recourse solely to the assets held under the AHC. Additionally, in the case of share pledges, any breaches in the loan conditions are then enforceable against the AHC rather than all the parties involved offering greater legal certainty and reducing administrative costs.

Administrative ease: Within real estate fund structures, AHCs offer the administrative ease of being able to be sold without the need to dispose of the underlying asset. The prospective benefits include not needing to transfer existing contractual arrangements, acting in accordance with local market expectations, facilitating portfolio (or sub-portfolio) exits and retaining the ring-fencing within the AHC.

Tax Neutrality: AHCs, much like investment funds, seek to achieve tax neutrality for investors. Where AHCs are set up for any of the commercial and administrative reasons outlined above, the tax regime of AHCs looks to ensure that the introduction of the AHCs does not end up with additional tax leakage compared to direct investment in the underlying assets. AHCs can also be useful for funds particularly those set up as limited partnerships or other tax transparent or exempt vehicles that may themselves not be able to access tax treaty benefits, to enable underlying investors to retain the treaty benefits they would have been entitled to in their own right.

Simplified Tax Administration: As detailed above, AHCs facilitate access to treaty relief in their own right rather than requiring each investor to file treaty relief claims. Additionally, AHCs are also often utilised as tools to reduce administrative burdens associated with the taxation of real estate. Where tax filings and reporting obligations are present, an AHC can act as an administrative blocker ensuring only a single return or form is required, instead of multiple filings for multiple entities.

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

AHCs are prevalent throughout the investment universe, and are used to provide the benefits outlined in our response to Question 1 when the investment itself does not provide them. As the Consultation mentions, the most common of these sectors are Private Equity, Credit and Real Estate. Infrastructure is another asset class that uses AHCs for similar reasons. Additionally, AHCs are also commonly used in joint ventures or similar arrangements which are not funds in their own right.

The Consultation document in paragraph 2.8 refers to AHCs being used predominantly in closed-ended fund structures. This is however not always the case within real estate structures where funds can be open-ended, closed-ended or a hybrid of the two. All variants are likely to utilise AHCs.

On the types of pooled investment structures which use AHCs, our members have provided examples of all manner of fund types, legal and regulatory structures including Luxembourg limited partnership (société en commandite simple or SCS) and the special limited partnership (société en commandite spéciale or SCSp), Irish Common Contractual Funds (CCFs) and many others. AREF's recent proposal for Professional Investor Fund (PIF)[2] in the form of an unauthorised closed ended transparent entity, would also seek to make use of AHCs for the same reasons provided. Historically UK funds have not been prolific in utilising AHCs within their funds' structures due, in part, to a number of regulatory issues including strict holding requirements of the FCA COLL handbook. To the extent a new regime emerges or amendments to the existing regime made to lift these types of barriers, the industry may see more UK Funds utilising AHCs in the future.

To that end we believe that the diagram presented within paragraph 2.9 of the Consultation while useful, portrays a rather simplistic a representation 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 shielding for individual projects.

The above illustrates that AHCs can perform single or multiple functions within a structure, depending on investor need. We therefore strongly urge that any solution considered in response to this consultation is flexible to allow existing and future investment structures to benefit from the changes. This is particularly important as the wider UK fund regime review develops and results in new fund regimes or vehicles for holding alternative fund assets including the Professional Investor Fund proposed by AREF.

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 stable, predictable and competitive AHC regime is likely to be attractive to UK and non-UK funds to use those vehicles and also encourage alternative funds being set up in the UK in the future.

A credible AHC regime would provide an opportunity to those investment managers that have significant UK operations and have had to set up investment holding structures outside the UK merely due to the absence of a competitive UK regime. Additionally, there are many investment management businesses that have over the years built significant operations and presence outside of the UK, even while carrying out investment management from the UK. For these businesses, the shift is likely to be gradual depending on investor demands as well as changes to other parts of the UK fund regime.

[2] https://www.aref.org.uk/resource/new-fund-vehicle-proposed.html

We have set out below some of the important economic and fiscal benefits of AHCs being established in the UK:

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 far more significant than direct fiscal benefits. Funds which cannot overcome tax barriers and introduce additional layers of taxation for investors often cannot get over the commercial hurdles of competing with funds which do.

Economic and Indirect Fiscal Benefits

Broadly the potential economic effects of greater amounts of capital being brought onshore through AHCs can be split into two areas.

Ancillary Services: The servicing of real estate held by AHCs is not insignificant and requires a number of support sectors. These include auditors, administrators and legal firms involved in the creation and on-going servicing of such vehicles. Both Luxembourg and the Channel Islands have seen demonstrable benefits in having these industries built around the AHCs in question. These services are likely to drive job creation and therefore Income Tax receipts, National Insurance contributions of those employed in the sector and may also drive indirect Corporation Tax revenues through additional fees being generated within the UK.

The IMA/ KPMG 2007 study on authorised investment funds[3] showed that every £1 billion of Funds domiciled in the UK, generates nearly £1 million of tax additional tax revenue per annum. Although the report focussed only on authorised funds, anecdotal evidence from members suggests that this provides a good indication of potential fiscal benefits of UK AHCs.

Management of Fund Structures Utilising AHCs

The UK continues to be seen as a powerhouse for fund management. As the Consultation identifies, the UK asset management sector is the largest in Europe and the second largest globally, with around £9.1 trillion assets under management. The UK regulatory and tax environment must evolve to remain competitive and understand the threats posed by smaller, more nimble fund domiciles.

Once the initial hurdle of setting up in a location is overcome businesses then seek to optimise the level of activity out of each of their operational bases. Even if the UK does not see widescale benefits of amending the AHC rules overnight, lagging competitiveness in this area risks eroding the UK's position across all of the financial services landscape over time. In this sense remaining

[3] https://www.theia.org/sites/default/files/2019-05/20080124jointimakpmgreport_0.pdf

competitive in the area of AHCs should be considered an important defence measure in the UK's overall competitiveness strategy.

The IA Investment Management survey 2018-19[4] shows that the UK is the fifth largest European domicile with €1.5 trillion in equivalent UK domiciled funds and a market share of 10%, compared to a 27% market share of Luxembourg domiciled funds and 16% for Irish funds.

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?

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

For the real estate sector, the following are the key tax obstacles in setting up UK AHCs. Many of these are also relevant for other asset classes including credit, private equity and 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, however puts the UK at a considerable competitive disadvantage, both from a tax drag and a promotional perspective, and it is no coincidence that common AHC jurisdictions like the Netherlands and Luxembourg do not apply interest withholding.

The UK withholds 20% tax on interest paid. 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.

While there are ways in which interest withholding tax can be managed, each of these available options can be expensive and onerous to implement. These include:

(a) **Quoted Eurobond Exemption** (QEE), which allows for gross payment when a bond or loan meets certain conditions. The bond or loan must be securitised and be listed on a recognised stock exchange. This however is costly for businesses to do and only available for debt structured in certain ways. It should also be noted that the QEE was brought in the 1980s to help create a bond market for UK companies. Initially it was restricted to quoted bonds, and as a result, issuers began to list on stock exchanges which minimised listing costs but where trading activity was low or non-existent. Overall the current position now appears to have been arrived at by accident, and the QEE is no longer relevant as the quoting process provides no real economic purpose anymore.

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

(b) The relatively recent **Qualifying Private Placement** (QPP) regime is another avenue which can be used by AHCs to exempt payments of interest from UK withholding tax. While a welcome development in itself, it has its own set of artificial conditions and places unacceptable levels of risk into loan arrangements with on-going monitoring requirements which again can prove costly and confusing to non-UK residents when compared to shareholder debt in a number of other jurisdictions which is generally less expensive, quick and easy to implement.

(c) Finally, payments to non-UK residents can in some instances benefit from double tax treaties. While it allows some investors to receive interest gross, it isn't as straight forward as an exemption as provided by other territories that do not require a pre-clearance or requirement for reliance on a tax treaty.

Substantial Shareholding Exemption (SSE)

One of the main challenges for real estate funds is the 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 ("QIIs"), the SSE will not apply to disposals of shares in companies carrying out real estate investment activities. In contrast, the participation exemptions available in other countries do not generally distinguish between trading and investing companies and can therefore be more widely applied.

Although the SSE rules provide for an exemption for QII, the QII exemption applies to a limited pool of investor types. Additionally, due to the legal nature of real estate funds, it is not always possible for groups to trace through entities to the QIIs particularly where funds are set up in a legal form other than a limited partnership or a company with share capital.

Hybrid mismatch rules

The UK anti-hybrid rules are another key issue for funds due to the way investment funds and AHCs are viewed across different investor jurisdictions. Additionally, to the extent that a UK holding AHCs is used in a structure with underlying non-UK entities, these rules present an additional risk of bringing these entities within the UK rules, which are generally broader than those adopted internationally by other jurisdictions. The complexity of the UK rules means that even if these rules do not apply, investment managers need to spend considerable time and resources to assess the impact of the rules and their interaction with other parts of the UK tax legislation including corporate interest restriction rules.

Other issues

The UK's exit from the EU will result in loss of access to the EU Parent-Subsidiary Directive and the EU Interest and Royalties Directive for UK entities after the transitional period. Continued access to these directives would have offered UK AHC's an automatic EU withholding tax relief without relying on double tax treaties. With this access falling away, and some relevant double tax treaties providing for a higher rate of withholding tax than under the directives, this without more would put UK AHCs in a less attractive position for holding pan-European assets than one resident in a suitable EU Member State.

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

In the recent years, there have been a number of international tax measures including in particular 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 efforts along with the changing regulatory landscape have led to some businesses reviewing the design and location of their fund structures. As we have explained in our response to Question 3, this has meant that rather than seeing AHCs relocate back to the UK, further investment has been made in the form of additional office space and hiring of new employees in other jurisdictions to increase local substance. The availability of local talent pool and office space in these locations is however limited and increasingly becoming expensive to sustain.

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 pension funds could work in favour of UK’s position as a suitable alternative funds and AHC location.

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

The UK company law requirement to have distributable to reserves for paying dividends are 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. 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. Overseas fund vehicles are quick and easy to set up, provide transparency and are less restrictive as to who can invest in those funds. A UK regime needs to offer similar ease of set up and flexibility in order to be equally competitive. In this regard, we welcome the UK fund regime review and the review of VAT in fund management.

The UK’s exit from the EU raises questions on the future of the UK’s relationship with the EU, the marketability of UK vehicles to EU investors as well as access to EU investments. At the same time, it also offers an opportunity for the UK to refine its tax and regulatory framework thereby making it an attractive fund location.

Equally important is the consideration of the company law and regulatory framework which is easier to manage in some common non-UK fund and AHC locations.

When considering the benefits of any changes, whether they be regulatory or tax in nature, it is important to understand that even wholesale change to the UK AHC eco-system is unlikely to change investor behaviours overnight. Jurisdictions such as Luxembourg, the Channel Islands and to a lesser extent Ireland; have built up their reputations over a period of years and existing platforms have been successfully achieved through considerable private cost. Investors may continue to prefer well established and well understood regimes offering future certainty of outcome.

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

We have set out below some of the measures that will help address the barriers that currently exist for AHCs being set up in the UK:

1. **Interest withholding tax**: This could be done either by introducing a specific exemption aimed at AHCs / funds or through removal of interest withholding for all payments except those made to individuals. 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. The latter, on the other hand, is likely to be easy to apply in practice and likely to the preferred option across the industry, supporting the ask of a simple and certain tax regime. In order to deal with tax avoidance concerns in a broader exemption, specific targeted anti avoidance measure could be introduced.

   In the event that neither of the above options is possible, then at the very least, investment fund vehicles (especially investment LPs) should be brought into the category of entities that are eligible for gross payment, as the current rules do not work unless all the investors are either UK corporates or UK institutions (which in practice means that a GP LLP or a single non-UK but treaty eligible investor breaks the whole fund even though they would get gross payment if paid direct). This could be based on a passporting regime to prevent abuse. Ideally LPs could either just confirm that all investors are eligible for gross payment (including other partnerships or treaty eligible), or have the option to take on the withholding burden themselves if not all are.

2. **Substantial Shareholding exemption:** Simplify the substantial shareholding exemption rules much like participation exemptions available in various jurisdictions 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 that UK does not lose the taxing right for UK property and to deal with avoidance.

3. **Hybrid mismatch rules**: It is reasonable to have anti-hybrid rules to prevent double-dipping / mismatches within fund structures, or between fund and investors where these mismatches are deliberate features of the fund. However, the requirement to consider the

investors' tax positions (often difficult to determine in practice) creates practical difficulties for funds which importantly have not been designed to achieve a tax mismatch but one arises just because some investors happen to be in a territory which treats (or may do) the fund vehicle differently from the fund jurisdiction, resulting in a reverse hybrid at the fund level or an imported mismatch in an AHC. This is not helped by the fact that the nature of a fund means that a manager is making decisions on behalf of the whole fund and/or the investors are considered to be connected by virtue of being participants in the fund partnership, meaning that otherwise unconnected investors are considered to be acting together. Rules in other jurisdictions alleviate this issue by not considering investors in a fund as 'acting together' if their decision to invest in the fund is made independently of one another, and by not imposing an additional burden on the manager to establish whether investors are acting together if they each own less than 10% of the fund and the manager is not otherwise aware of any connection. The UK should apply a similar approach to UK AHCs and indeed UK funds.

4. **Review of other aspects of the UK fund regime including VAT** to ensure that the VAT treatment of onshore AHCs and relevant fund vehicles is competitive to the VAT position of offshore vehicles. In this regard, we welcome the governments review of VAT charged on fund management fees.

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

Amendments to the existing regime as outlined in our response to question 8 as well as consideration of non-tax barriers mentioned in our response to question 7 will help remove barriers that currently deter holding companies from being set up in the UK. It is important that tax and non-tax barriers are considered at the same time in order for the overall UK regime to be on par with regimes currently offered by other jurisdictions.

It should be noted that the above changes need to be considered even where a new regime for AHCs is planned to be introduced, in order to preserve optionality for businesses to access the regime or rely on the wider UK tax rules, based on individual circumstances. To the extent that a specific AHC regime is considered, it is critical that it has a broad entry criterion so as to allow wider range of entities to access the regime. To the extent that a specific regime offers tax exemption, it could also create a risk that the vehicle is denied double tax treaty benefits or the benefit of certain domestic exemptions in other countries if it is not subject to the same tax rules as other companies.

We therefore strongly urge that any new specific regime is widely consulted on with the industry from the outset to ensure that it is fit for purpose and does not inadvertently create additional tax issues or exclusions for certain vehicles.

Thank you once again for the opportunity to respond to the consultation and we hope to continue to be able to continue our contribution. If you have any queries or require further information, please do not hesitate to contact me.

Yours sincerely

Paul Richards
Managing Director, The Association of Real Estate Funds