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# CREFCE response – Tax deductibility of corporate interest expense: draft Finance Bill clauses published 26 January 2017

## Introduction

The Commercial Real Estate Finance Council (**CREFC**) Europe is a trade association promoting a diversified, sustainable and successful commercial real estate (**CRE**) debt market in Europe that can support the real economy without threatening financial stability. Our core membership includes lenders and intermediaries who help connect capital seeking the risk and returns of CRE debt with real estate firms seeking finance.

We are grateful for the opportunity to comment on the draft Finance Bill provisions relating to interest deductibility as published by HM Treasury (**HMT**) on 26 January 2017.

In preparing our response, we have had the benefit of reviewing the submission to be made by the British Property Federation (the **BPF**), which represents the views of businesses in the UK that own, manage and invest in property.

In common with the BPF, we welcome the broadening in scope of the Public Benefit Infrastructure Exemption (**PBIE**) which should (in general) help provide much needed certainty to certain real estate businesses. However, we also share the BPF's concerns (as reflected in Appendix 1 of their submission on the PBIE) that challenges remain in the approach taken in relation to the PBIE, which will need to be overcome if the PBIE is to be effective in protecting CRE finance that does not present BEPS risk. In addition, for those real estate companies not able to benefit from the PBIE, we are concerned that the group ratio rule in particular (as currently formulated in the draft Finance Bill clauses) does not seem to be capable of guaranteeing the deductibility of straightforward third party interest expense for capital-intensive industries like real estate.

As a general matter, we agree with the Key Recommendations and other comments made by the BPF in their response, and do not generally repeat those views here. However, there are certain issues raised in the consultation in respect of which we consider it appropriate to provide comments separately and we set these out below.

## Background

The functioning of business in the wider economy relies on investment into CRE. It provides the accommodation businesses need, and a professional CRE industry that makes premises available to rent provides ordinary businesses with the flexibility to adapt and relocate with changing economic conditions and commercial requirements.

As a capital intensive and long-term business often involving very large, valuable and illiquid assets, CRE is dependent on the ready availability of debt finance. This dependency is driven principally by the very different risk and return expectations (and hence cost) of different types of capital. A typical CRE funding is likely to involve a mix of equity and third-party senior debt, and may also involve mezzanine and/or junior debt (provided by a third party finance provider or a related party). Debt can be provided directly

to the property-owning company; alternatively the funding can be provided indirectly (including for reasons of structural subordination): here, the third party lends to a holding company of the property-owner, with the funds then on-lent intra-group to that owner.

While we are wholly supportive of the Government's plans to counter tax avoidance by multi-national enterprises, more work is needed to avoid material collateral damage in important industries like real estate, especially where available exemptions like the PBIE won't work.

Development finance is one such area. The recovery of development finance since the global financial crisis has been somewhat anaemic. Banks have remained relatively cautious (in part put off by higher regulatory capital costs as well as greater sensitivity to risk generally). Non-bank lenders have been more enthusiastic, but in volume terms they start from a low base.

Real estate development is good for the economy as a whole, especially when, as now, the risk of oversupply is low. It also presents very low BEPS risk, given the typical use of UK sourced debt to fund the development of UK assets. Yet the government's proposals for implementing OECD recommendations and its preferred solutions for protecting low-risk financing in the real economy seem set to weaken still further the flow of credit for real estate development.

We are also concerned that the speed with which these proposals are being rushed into law has left many lenders behind. Financial institutions have had to concentrate on how the proposals might affect them directly, and few have really got to grips with how their lending practices should change to accommodate new interest deductibility restrictions of considerable complexity.

## General comments

### 1. The PBIE must work for CRE finance

We welcome the inclusion of property businesses within the PBIE. We anticipate that this will be relied on by both lenders and borrowers within the CRE sector to provide the certainty as to cash flows that non-recourse financing requires. It is therefore important that the PBIE achieves the policy aim underlying its extension to commercial property businesses.

CRE lending is a particular type of "specialised lending" where the lender's recourse is typically limited to the asset or group of assets being financed (and, often, one or more single purpose companies that hold the asset or group of assets). We set out in the Schedule a summary of the key elements typically found in such a non-recourse CRE financing. It is important that, in structuring the PBIE, the government take into account the commercial understanding of the term (as reflected in the regulatory description) and that this safe harbour is not so prescriptive that it becomes a special tax concept mismatched with the commercial reality of such financing arrangements

As stated above, we share the BPF's concerns (as reflected in Appendix 1 of their submission on the PBIE) that some challenges remain in the approach taken in relation to the PBIE. In particular, the government should reconsider:

- the proposed definition of non-recourse financing in section 431 (especially the exclusion of all forms of guarantee, regardless of their relevance to a BEPS risk). This is most important in the context of development finance (see Background section above), where the use of guarantees is widespread; and

- the need for the comparative debt condition: a non-recourse lender looks only to the asset/activity it is financing when making its credit decision, and not to what other companies in the (worldwide) group are doing and/or borrowing. The comparative debt test means that the availability of the PBIE is dependent

on factors outside the scope of the financial and commercial due diligence normally conducted in this market.

## 2. Transitioning to the new rules: timing and grandfathering

### *2.1 Timing*

We welcome the manner in which HMT has engaged with stakeholders on the implementation of these proposals since the original consultation on BEPS4-related measures published shortly after the OECD released its recommendations on Action 4. However, the timetable the government has set remains needlessly ambitious and is sure to cause problems.

This is illustrated in part by the fact that legislation dealing with core substantive aspects of the rules was only published as part of the "second instalment" on 26 January 2017 (with stakeholders being given four weeks to comment on complex legislative drafting, as compared to the usual eight weeks contemplated by the Tax Policy Framework). This curtailed timetable has been imposed at a time when broader political and economic risks may be distracting many of those potentially affected, and with no objective justification for urgency. It is difficult to believe that the legislation really will be "near-final" when the Finance Bill is published following the Budget – possibly as little as two weeks before the new rules take effect!

We agree with the BPF that implementation from April 2017 will not allow business sufficient time to consider the impact of the measures, let alone give business time to adapt. Few CRE lenders will have had sufficient opportunity to understand the new rules (some still don't appreciate that they will be affected by them), nor to work out how their financial modelling and lending practices should change to accommodate them.

Haste can undermine the benefits of moving quickly and decisively. The UK should delay implementation of the new interest limitation measures until accounting periods beginning on or after 1 April 2018. This will provide policymakers, business and practitioners with the time needed to scrutinise the relevant legislation effectively and allow both business and HMRC a suitable period to prepare for their implementation (including a new compliance regime).

### *2.2 Grandfathering*

The provision of debt on commercial terms by an unconnected finance-provider by itself has nothing to do with base erosion or profit shifting. Where such debt is financing UK assets – as is the case with CRE finance involving non-recourse loans secured on real estate located in the UK – there is little if any BEPS risk. The tax treatment of third party debt should (as the BPF argues) be grandfathered.

That would also be fair and avoid unnecessary disruption to existing arrangements. For existing loans, investment decisions (both the decision to lend and the decision to borrow) will have been taken on the basis of financial models containing assumptions as to tax deductibility of interest expense. A borrower may find itself in breach of loan covenants for no other reason than the impact of these proposals on the cash flows on which the financing was based.

Covenant breaches can in turn trigger defaults, resulting in lenders taking appropriate enforcement measures against borrowers. To avoid that, parent sponsors might enter into arrangements with lenders to support borrowers and address cash shortfalls (something that, in particular cases, might even prevent a financing from benefiting from the PBIE).

Or a borrower may opt to prepay its loan – even at the cost of prepayment penalties (whether under the loan, or under a related derivative entered into to fix the interest cost over the term of the loan). The

majority of CRE loans have a maturity of between 3 and 7 years[1], and some (such as those provided by insurance firms, or funded through the capital markets, including commercial mortgage-backed securities (**CMBS**)) may have even longer terms, with particularly expensive prepayment provisions.

Lenders and borrowers will need time to assess what the new provisions, including the PBIE, mean for existing financing arrangements. Even if the government decides to defer the introduction of the new rules to April 2018 (as we and the BPF are asking), we consider lenders and borrowers may still need more time to plan for and implement any necessary restructuring of existing arrangements.

And all of this in cases where the mischief at which these proposals are aimed is completely absent. This is not good policymaking.

The government should provide full grandfathering for third party loans that were entered into before (at least) May 2016.[2] If the government is not willing to contemplate "blanket" grandfathering of all third party loans then, at the very least, the grandfathering provided for in section 432 (Exemption in respect of pre-13 May 2016 loan relationships) should be extended to apply to non-recourse UK CRE financing arrangements.

Further, we agree with the BPF that, for existing non-recourse CRE financing arrangements the provisions in Chapter 8 (Public Infrastructure) relating to parent guarantees should not apply: in particular, sections 431(4) and (5) should not prevent otherwise qualifying debt from qualifying for the PBIE.

## 3. CRE debt is not provided solely by banks

The group ratio test applies only where debt is provided by a non-related party. The PBIE only exempts amounts payable to a non-related party or another qualifying infrastructure company. The definition of related party is therefore key if borrowers are to be able to obtain full tax relief for genuine third party financing costs.

The meaning of "related party" is very broad, but helpfully a bank lending in the ordinary course of its business can in certain contexts benefit from a safe harbour (see sections 450 and 455). The problem is that in the evolving post-crisis financial landscape, it is not appropriate (and may create competitive and structural problems) to make this safe harbour available only to banks.

Although the CRE sector historically sourced third party debt mostly from the banking sector, over recent years, supply has diversified. This is widely seen as a healthy development, which helps disperse potential financial stability risks that were concentrated within the banking system before the global financial crisis.

This diversification of supply is also good for borrowers in the real economy, because a wider range of sources of debt increases the range of debt products available and reduces the risk that the whole market turns supply on or off at the same point in the cycle. There are now a range of new sources of institutional and private capital supplying the CRE industry's credit needs either directly or through fund management platforms (including the direct lending funds referenced in the carried interest legislation).

The safe harbour currently proposed for banks seeks to ensure that, where a borrower raises finance from a bank in the ordinary course, it has certainty as to the treatment of that finance as a third party loan when applying the group ratio. Exactly the same policy rationale applies where the borrowing is from a different type of lender acting in the ordinary course. Limiting the scope of the safe harbour to banks fails to reflect

[1] For example, the De Montfort Commercial Property Lending Report 2015 recorded that 65% (by value) of all new investment loans in 2015 were written for a period between four and seven years.

[2] Being the date when the Consultation on design of the measures was launched – and so the earliest date on which detail about the possible terms of the legislation was provided publicly to business.

the 21st century evolution of the lending landscape and risks operating in an anti-competitive way. The safe harbour should be extended to apply to all "ordinary course" lenders.

## 4. Simplicity: the importance of guidance in creating a workable regime

The draft legislation contains a significant number of new tax definition and concepts. Although there is some (limited) cross-over with the worldwide debt cap rules, the legislation represents a fundamental shift in the treatment of corporate debt, and a new approach to restricting deductibility. In particular, it owes more to concepts deriving from the OECD's BEPS project than to existing UK tax law.

Working through the base rules – given the need to identify relevant information and make the required adjustments – will be challenging enough for companies that, with their advisers, must familiarise themselves with the new regime. However, in addition, the rules now provide for optionality – with various elections built into the methodology (to try to avoid unintended consequences). Whilst we welcome the policy intention underlying the inclusion of these alternative applications of the rules, it makes the overall regime even more complicated for those seeking to assess the impact of the reforms on a borrower's tax position.

It is important, in this context, that draft guidance as to HMRC's views on the operation of the rules (with relevant – and appropriately detailed – examples) is published as early as possible to help business prepare for their introduction (especially if the government remains determined for that to be on 1 April 2017). That guidance must be clear and unambiguous to help people understand the practical effect of these measures.

HMRC should in any event publish a user-friendly guide/helpsheet on the application of the base rules at the same time as the Finance Bill is published after the Budget: in effect, a step-by-step guide as to the different elements that need to be taken into account when working out a group's disallowance position (including statutory references). Groups will need to get to grips with what the rules mean for them very quickly – particularly given the time-limits that apply to various transitional measures and the making of elections.

We anticipate that, within the CRE finance sector, lenders and borrowers will look to the PBIE as a means of providing the certainty as to cash flows that the market requires. Meaningful guidance on the PBIE (and "acceptable" reorganisations to fall within the PBIE criteria) should therefore be a very high priority (alongside finding solutions, within the PBIE or outside it, for CRE development finance).

The focus of much of the stakeholder engagement on these measures to date on policy, rather than detail: but on the basis that commencement remains 1 April 2017, the detail – and more importantly what it means in practice and in compliance terms – becomes key.

We remain at your disposal should you have any questions or require further details.

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# Appendix 1: Draft Finance Bill provisions – PBIE

## General

In general, the PBIE appears intended to confer exemption from the new interest deductibility rules on non-recourse CRE financings of the type summarised in the **Schedule** to this note. The conditions which apply appear intended to replicate the key commercial characteristics of such financings:

(a) the financing (and as result the exposure of the lender) is to an entity which was created specifically to finance and/or operate physical assets (the SPV);

(b) the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate; and

(c) the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise.

For the PBIE to work as intended, it is important that this safe harbour is not so prescriptive that it becomes a special tax concept that bears no relationship to the commercial reality of such financing arrangements.

A key issue here arises from the definition of "non-recourse financing" in section 431. The general approach as set out in subsections (4) and (5) reflects the approach taken in non-recourse CRE finance (and links to (c) above), but there can be circumstances where the lender looks to some form of arrangement with the sponsor/parent of the borrower to supplement its rights as against the SPV. This does not mean necessarily that the lender has recourse as such to the sponsor/parent to repay the loan; the credit assessment made by the lender remains one based on the cash flows (and value) of the assets being financed.

These particular types of arrangement are set out and explained in Appendix 1 of the BPF submissions (in section B, under the heading "Parent Company Guarantees"), and in particular those guarantees described as Completion Guarantees, Development Guarantees and Stabilisation Guarantees.

Completion and Development guarantees are sought by lenders because of the uncertainties around the development process. Because the credit assessment for the loan is based on the rental projections for the property, various assumptions will be made in the model as to the length of construction period and (where the loan is partially funding development) the costs of development. Should those assumptions prove incorrect, the lender is looking for assurance that the sponsor/parent stands behind its SPV subsidiary and will ensure construction is completed. The lender would not want to advance monies to the SPV and then, at the end of year 1, find construction has ended and its security interest is over an unfinished construction site with the result that it is unable to secure repayment of its loan in full unless it funds the remaining development work itself. In some ways, it is a performance guarantee: a guarantee from the sponsor/parent that the SPV will perform its obligations to complete the development project (on time), with the sponsor/parent standing behind the SPV if – and only if – that is needed. These guarantees are to protect the lender from the risk of "known unknowns" arising from construction.

A Stabilisation Guarantee is directed more towards "known knowns": following completion of a development, there is likely to be a period where the nature of the commercial property market means that, although the asset is then potentially income-producing, no income is actually produced and so the debt cannot be serviced absent specific arrangements. This could be due to a rent-free period, for example, or because the property is multi-occupancy and it may take time to market all units successfully. This is a guarantee linked to the nature (and performance) of the underlying asset that is the basis of the financing.

As set out in the BPF submission, the use of such parent company guarantees is clearly driven by commercial factors, most notably to mitigate specific known risks and to make the lender more comfortable to agree to the financing agreement. Fundamentally the guarantees look to the asset that underlies this particular form of financing (completion and development guarantees looking to ensure that the asset actually becomes income-producing); whilst at the same time recognising that the ring-fencing of that asset (within an SPV) that is required to give the lender the effective control it needs under a non-recourse financing means that the SPV will, on a standalone basis, have limited funds available to it (pending the asset becoming income-producing) to meet any unexpected contingencies (or, in relation to the stabilisation guarantee, the known delay between practical completion and the first rent payment).

We therefore agree with the recommendations made by the BPF in section B of Appendix 1 of its submission. In particular:

(a) the existence of a parent guarantee should not itself prevent the PBIE applying where the nature of that PBIE is such that its financial value is not expected to be significant. Further, where the guarantee has some (limited) additional value, a proportionate adjustment to the PBIE "relief" could be made on a just and reasonable basis (adopting the approach in section 431(2));

(b) parent guarantees on existing loans should be grandfathered, given the costs and other implications of renegotiating loans to amend the terms (for both lenders and borrowers);

(c) parent guarantees on development financings should be excluded entirely; and

(d) parent guarantees provided by companies which are part of a wholly UK group should be excluded because they represent a negligible BEPS risk.

In addition, we have the following specific comments on Chapter 8.

## Specific comments on Chapter 8

We set out below our comments on the draft legislation in Chapter 8, section by section. Our main concerns relate to:

- the non-recourse financing condition (section 431)
- the comparative debt test (section 427(7) to (9))
- the meaning of "insignificant proportion" and the five day leeway (section 427(2) and (3))
- the meaning of "public infrastructure asset" where there are multiple property interests (section 429(5)), and
- the application of the PBIE to an un-let asset (sections 426(3) and 429).

**Section 426**: This is stated to be an overview, but in general reads as an executive summary of the Chapter, giving rise to a risk of interpretational uncertainty. Given that the detailed rules are set out elsewhere, presumably section 426 should have a limited role in terms of interpretation of the more detailed provisions?

**Section 426(3)(b)**: This applies to buildings (or parts of buildings) that are let. It is possible that a building may be (in part or whole) un-let for a period, even though the owner is marketing it with a view to finding tenants. Therefore during an accounting period part may not be a "public infrastructure asset" for more than the five day leeway in section 426(6)(b) even though the intention is that it should be – and the

proportions let/un-let may mean the un-let proportion represents more than an insignificant proportion of total assets. Should the "are let" test be adapted to cover this (as has been done in section 429)?

This is also relevant to speculative development by an investment company. The investment company may be developing to hold (as opposed to developing to sell). Even if it enters into a pre-let of the property, that pre-let will generally be conditional on practical completion. Until practical completion there is no letting as such: just an agreement to lease if certain conditions are met.

In this context, we agree with the comments of the BPF on section 429(5) (the substantive provision that concerns the meaning of public infrastructure asset) that the PBIE should apply where a company "intends" to carry on a property business.

(This is not an issue for other types of infrastructure defined by reference to the nature of the asset, not how it is used.)

**Section 426(4)(b)**: In terms of the requirement that an asset is shown in a balance sheet of a "member of the group":

(a) first, we assume the reference to "group" is to the "worldwide group"?

(b) secondly, is there an implied requirement as to how the asset is shown in the balance sheet (in terms of categorisation)? This links to section 427(3)(a) which refers to assets being shown as "tangible assets". But section 429(9)(a) suggests that an asset can be shown "otherwise". Clarification is needed as to whether the categorisation for accounting purposes of the building is material in relation to Chapter 8.

**Section 426(6)(a)**: Should the alternative exclusion say "the amount is in respect of an old qualifying loan relationship" rather than "the amount is in respect of a loan relationship entered into on or before 12 May 2016"?

The current drafting implies a broader grandfathering than is currently conferred by section 423. Although this limb cross-refers to section 432, given the relative detail of the description within this "overview", should this signpost upfront that the grandfathering is more limited than this suggests?

**Section 426(6)(b)**: Given the signposts at subsection 6(a), should a reference to section 431 be added at the end of subsection (b) (particularly given the words "(ignoring certain financial assistance)" which is a term defined specifically for the purposes of this Chapter[3])? The signpost would confirm the specific meaning for these purposes.

**Section 426(7)(a)**: The signpost at the end provides a "for example", which is limited to one consequence only: should the example be deleted, and replaced by a "signpost" in the form of a cross-reference to "(see sections 433 to 436)". This would direct the reader to the relevant provisions, and be of more use than a limited "for example": particularly given that the purpose of this provision is to highlight what else is in the legislation, rather than apply "law" as such.

**Section 427(2)**: What is meant by "insignificant proportion" in this context? Guidance on how this is to be interpreted should not just be limited to a percentage, but should provide useful and realistic examples in order to provide some flexibility in practice (as opposed to a cliff-edge). We agree with the comments of the BPF on the need for there to be flexibility in how this is interpreted in practice, and that 10% would be an appropriate threshold.

[3] Particularly given that this term is more commonly understood within a Companies Act context.

Further, what amounts to "income" for this purpose: is this a tax or accounting test? The reference to loan relationships suggests a tax-based test; but the assets test is based on the company's balance sheet. In the REIT rules, for example, the income/asset balance of business test is based on financial statements (not tax) and this test operates in an equivalent way.

How will the test work when, say, a property is in the development phase? Pending completion (and letting) of the property, the company will not receive rent. Instead, its main source of income is likely to be interest on bank accounts in which it holds its development funding. Would such be "qualifying" given it arises from a deposit of monies being used to fund its provision of a qualifying infrastructure asset: would this be an ancillary or facilitating activity within section 429(1)(b)?

Similar issues also apply to rent-free periods and voids (including where there is a tenant insolvency): the five day leeway in section 427(6) may not be a sufficient safe harbour in this context.

**Section 427(3)**: What is meant by "insignificant proportion" in this context? Guidance on how this is to be interpreted should not just be limited to a percentage, but should provide useful and realistic examples in order to provide some flexibility in practice (as opposed to a cliff-edge).

Under the test, there is a requirement to (in effect) assume a daily balance sheet as a means of testing continuous ownership of the asset. There is a relaxation in section 427(6): but this is subject to a maximum five day period. This could create issues where a group sets up a new company (a single purpose company (**SPV**)) for a new business. Such a company would be set up in advance of the start of the property business, but may be in the charge to corporation following incorporation (for example, it may have a source of income before it acquires the relevant public infrastructure asset (e.g. if equity funding has been invested pending acquisition of the asset).

This pre-commencement period could be more than five days in practice. The income it receives pre-commencement should generally be insignificant in proportion to the income generated by the PIA when acquired; and would be temporary. Although the company could reset its accounting reference date as soon as it has the asset, and thus commence a new accounting period by reference to which the test is applied, it would be preferable if that first accounting period could benefit from some leeway in relation to the asset test for that "post-incorporation/pre-acquisition" period.

Similarly if a company disposes of a public infrastructure asset, it will not as a result end an accounting period (a period continues as long as the company has a source of income within the charge to corporation tax). Again, the combination of sections 427(3) and (6) mean that a company may cease to be eligible for the PBIE within the accounting period in which makes the disposal - even though activities after that date are minimal. This is because the test is a "throughout the accounting period" test.

Again, a company could then try to change its accounting reference date: but it would be simpler for the legislation to address this (perhaps be deeming an accounting period to end for the purposes of these provisions at the point qualifying infrastructure activities cease because the public infrastructure asset is sold).

We agree with the comments of the BPF on this condition in Appendix 1 of its submission.

Finally, assume a company accumulates a cash surplus from its qualifying infrastructure activities. As that cash arises, it will be qualifying income within section 427(2). Over time, it will be shown on the balance sheet as "cash at bank" (for example): at that point, must reliance be placed on it being no more than "an insignificant proportion" of total assets regardless of its source?

**Section 427(3)(a)**: Does "tangible asset" bear a tax or accounting meaning?

**Section 427(4)(a)**: There appears to be an omission from the draft: i.e. something appears to need to be added between "in relation to the company" and "that are provided by the company". Should the reference be to activities provided by the company?

**Section 427(4)(b)**: Guidance will be needed to explain the type of arrangements within this limb (and to provide examples).

**Section 427(5)**: See comments on section 429(3) above. A company will not generally be monitoring asset values on a daily basis and so would not be expected to know what value would be shown on a particular date mid-accounting period. There needs to be flexibility about how the asset test is applied: we agree with the BPF suggestion of a fixed date (beginning or end of the accounting period) for this test.

**Section 427(6)**: See comments on sections 427(2) and (3) above. The five day leeway period is too limited in relation to these tests.

We agree with the BPF that limb (a) should be sufficient; with guidance providing an indication of how "temporary" is to be construed. This would allow account to be taken of commercial circumstances in assessing if a company met the test.

**Sections 427(7) to (9) (comparative debt test)**: We understand that the rationale behind this provision is to address the potential BEPS risk of groups over-leveraging UK projects (as compared to those in other jurisdictions).

However, the approach taken in the legislation in some way cuts across the purpose underlying PBIE in relation to providing a safe harbour for non-recourse debt.

Under a standard CRE finance model, the lender takes risk solely on the relevant asset and its cash flows, and has no recourse other than to SPVs holding that asset (whether directly, by way of asset level security, or indirectly, by share charges over the share capital of those SPVs). The nature of such finance means that the lender will model expected borrower cash flows – taking account of rental income, interest, other property related costs and tax – at the outset, and such model will influence not only credit decisions, but also the terms of the loan.

In this context, a CRE lender will generally test the borrower's ability to pay (through interest cover tests) by reference to the rental income of the property it is financing. The lender is looking for as much certainty as possible when carrying out its due diligence: the lender wants to be clear (on a forward looking basis – i.e. throughout the term of the financing) that its loan will be paid out by those expected cash flows.

The nature of the fixed and group ratios – which mean the deductibility of interest under a non-recourse arrangement would be dependent on the position of the broader group (not just the SPV) – would make it very difficult for a lender to obtain the required degree of confidence as to the accuracy of any model prepared based on expected cash flows. The only safe assumption would be a conservative one, significantly reducing the amount the lender is willing to lend.

Although, broadly speaking, the PBIE is intended to ensure that the tax treatment reflects the non-recourse nature of the financing by ring-fencing a qualifying infrastructure company, whether or not this objective is achieved depends on the detail of the conditions. As we stated in our comments on the Consultation, it is important that, in shaping any definition of non-recourse finance, he government takes into account the commercial understanding of the term (as reflected in the regulatory description) and is not too prescriptive in creating a special tax concept.

The adoption of the comparative debt test in its current form risks creating that special tax concept – and risks the SPV's position becoming again dependent on things happening elsewhere in the group. It bears no relation to the reality of non-recourse lending: the lender will not look to what other companies in the

UK group (let alone the worldwide group) do and/borrow. Their focus is solely on the asset, its cash flows and the SPV borrower. We therefore question whether this condition is indeed necessary given the other conditions, and in particular the non-recourse conditions in section 431.

If the comparative debt condition remains (whether in this or an amended form), it is vital that it is capable of being applied in a relatively simple and straightforward way. This does not seem to be possible on the basis of the current drafting.

As currently drafted, it recognises that not all infrastructure activities are the same (so it applies to companies carrying on "similar activities" and allows adjustments to be made to take account of "all circumstances relevant to determining what is an appropriate amount of indebtedness". The test is, within statutory form, relatively fluid. But this means that there could be significant challenges in practice in working out how it applies

If it remains, there needs to be clear guidance as to how it will work, particularly given it seems to assume that a reasonable conclusion can be drawn "each day" in a period. (In reality, it is likely that this would ultimately be tested at the end of an accounting period when preparing the tax return – and assumed at the beginning of a period (or even slightly before it starts) when a company determines its instalment payments.)

As a drafting matter, in subsection 427(7)(b), is it intended that the comparative debt test is not between actual total indebtedness as subsection (7) provides, but between total debt of the qualifying companies and what is determined as the "reasonable level" of debt for the comparable entities (given the expected need to make adjustments), rather than the actual (given the need to make the adjustments)? This difference is presumably intended to be covered by the fact that subsection (7) is stated to be "by reference to"... rather than setting out what the test actually is (which is subsection (9)). Guidance could usefully clarify this.

In addition, is total indebtedness to be tested on a consolidated basis, so that intra-group debt within the group cancels out?

Further, there would need to be clear guidance on:

- the basis on which a taxpayer can be confident that something can be "reasonably concluded" (i.e. what needs to be done to support a conclusion so it can be proved to have been reached reasonably?);
- when debt would be regarded as "significantly higher" so as to cause the condition to be failed;
- when activities are similar; and
- what adjustments can/should be made under subsection (9) and what circumstances are able to be taken into account. For CRE finance, an "other circumstance" would need to include the identity of the tenant(s) given the impact of the tenant's credit on the viability of the cash flows.

Unless it is clear how this test will be applied, CRE lenders will not generally be able to obtain the certainty as to cash flows that they would look for on a non-recourse financing because of an ongoing risk throughout the term of the financing that the PBIE may be "lost" because of circumstances elsewhere in the group. One alternative would be for the test to be a "once only" test applied when the financing is taken out – this after all should be the material time for testing a BEPS motive to a particular arrangement; but even then, the test would need to be clearer than it currently is as to what is covered (so that a non-recourse lender and borrower can be certain that it has been met).

**Section 427(10)**: The test relates to every activity carried on at any time in the accounting period.

What is meant by "activity"? The UK corporation tax system is based on source. Source may derive from a particular activity (trading or ownership of income-generating assets, like CRE); but tax is on the income not the activity. (In this context, see also section 429(9)(b) which refers not to a company being within the charge to tax on its activities, but instead "in respect of all its sources of income". Clarification is needed as to how the two interact.)

In addition, is "activity" limited to an activity that gives rise to a "source" of income, or does it include an activity that gives rise to a chargeable gain (i.e. an actual disposal – we assume deemed tax events are excluded as they are a statutory fiction, not an activity).

Finally, if, as a technical matter, an activity benefits from a tax exemption, there can be a question as to whether an item is within the charge to corporation tax or not.

A REIT is clearly within the charge to corporation tax.

For a holding company (which can be a qualifying infrastructure company), its activity will be holding shares on which it may or may not receive dividends. Is receiving dividends an "activity"? If so, then Part 9A CTA 2009 says that "the charge to CT on income applies to any dividend ... but only if it is not exempt". In most cases, dividends will be exempt. Does a holding company that receives exempt UK dividends have an activity that is within the charge to corporation tax?

**Section 428(1)**: We note that this is supplemented by paragraph 27 of Schedule 1 (transitional rules) for existing companies – see comments in **Appendix 2**.

Where an election is made by an existing company, do the conditions need to be met for the deemed period commencing 1 April 2017, or is it for the whole actual period?

**Section 428(4)**: Could an exception to this rule apply if a company changes ownership after revoking an election? This would allow a new owner to determine the position under PBIE on a standalone basis.

A sale of a company may lead to the new group looking to refinance the asset: this restriction could therefore have an adverse impact on refinancing options (and given that the interest restrictions are a group test, it is the group, rather than the individual company, that will determine approach under these rules).

In addition, we agree with the comments made by the BPF in Appendix 1 of its submission under the heading "Irrevocability of Elections".

**Section 429(1)**: We agree with the comments made by the BPF in Appendix 1 of its submission on the need to clarify what is meant by activities "ancillary to, or which facilitate" qualifying infrastructure activities: see in particular "What activities qualify for PBIE".

**Section 429(5)**: Guidance should clarify how references to "part" are to be construed. Does this apply where the company owns "part" only (for example, it has a lease of part of a building only), or does it apply where a company owns an entire building but lets out only part: does that "part" letting qualify the building as a public infrastructure asset? We assume the latter: with the income/assets test then applying in relation to the un-let part.

In many buildings, there will normally be common parts that are not let to any single tenant, but over which access is allowed to all tenants (generally by licence). Given the "insignificant proportion" test, common parts should (in practice) not prevent a company qualifying notwithstanding their existence means that only part of a building is let to a third party. However, it would be preferable if, where a building is let out, the arrangements for common parts did not prevent the entire building being seen as let out to third parties (reflecting the commercial reality).

In addition, it would be helpful if guidance could address the not uncommon situation where a number of companies within the group have an interest in the same building. For example, company A has the freehold, company B a lease of 125 years, and company C a lease of 50 years (of which say 10 years is now remaining). Company C lets the property to a third party tenant.

Each company carries on a property business (so subsection (a) is met by all, as (a) does not seem to require that business to be one of letting to third parties).

Because of company C, the building is let to third parties (so subsection (b) is met by each company because of what company C does).

The economic life at each of A and B (i.e. that of the building as held in the group) is more than 10 years – and C's ownership had had an economic life of more than 10 years when it first acquired its interest; we assume (c) has to be met by each company by reference to its "own" interest? (Here, the drafting of subsections (b) and (c) links to the building overall, rather than a particular company's interest in it, but presumably this is to be construed by reference to each individual company's ownership interest separately?)

Is this a correct interpretation? This is important because in such a situation a lender would want security over each property interest to ensure that, in a default, it could take control of the asset. This means that the lender would want a fixed charge and other security over A and B's interests in the building, as well as Company C's interest (the one that is reversionary to the tenant). Given the recourse requirements in section 431, A and B therefore need to be qualifying infrastructure companies: as otherwise the PBIE would not apply.

Finally, while the phrase "is let" is defined, the phrase "is to be let" is not. Is the question of whether a property "is to be let" to be judged by intention? If an SPV owns one development property which is under construction with a view to a long-term hold, the condition that the building "is to be let" should be met, if based on intention, even if the SPV has not yet found a tenant. However, that SPV may not then carry on a property business (assuming this term bears the same meaning as in Part 4 Corporation Tax Act 2009), despite its intention to do so. Does the building still qualify? If not, that may make the market less accessible for prospective new entrants. Interestingly, the problem would appear not to arise if the SPV leased the building from another group company that owned the freehold, as subsection (5)(a) would be met by virtue of the property business carried on by the freeholder. This question is important in the context of development finance and should not, we think, depend either on the presence of intra-group leasing arrangements or on whether a wider letting property business already exists.

We agree with the comments made by the BPF in relation to the meaning of "property business" in Part C of Appendix 1 of its submission, and the importance of this in relation to development activity being able to qualify under the PBIE.

**Section 429(6)**: Guidance should comment on what would be regarded as an "other arrangement".

**Section 429(9)(b)**: See comments on section 427(10).

**Section 430**: No comments.

**Section 431(2)**: Given the absolute nature of the conditions set out in section 431, how is the reference to "just and reasonable" apportionment intended to operate in practice? For example, is this intended to catch interest payable under a loan/payments under a swap which only meets the conditions in part of a period – i.e. because its terms are changed midway through that affect recourse, or because the creditor changes?

If the company ceases to be a qualifying infrastructure company at any time in that period, no amounts will be an exempt amount in that period. Is this intended?

Subsection (a) seems to look to the person that is creditor in relation to the interest only (i.e. it does not refer to the underlying loan). This is because subsection (b) refers to the "recourse ... in relation to the amount" and "the amount" is the putative exempt amount, which links to an amount which would otherwise be tax-interest expense. We assume however that the intention is that the non-recourse obligations as referenced in subsection (4) are the obligations to pay interest and repay principal.

**Section 431(3)**: See comments in **Appendix 2** on the meaning of "related party".

**Section 431(4)**: At the moment, unless the terms of section 431(4) are met, the exemption is not available.

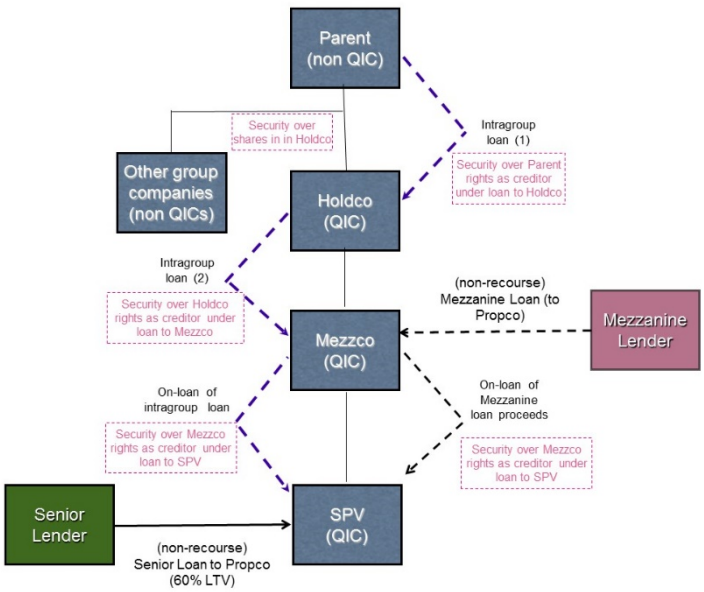
As explained in the General part of this Appendix 1, it is possible that, because of how the CRE finance market works, there may be guarantees of limited, negligible or no value given as part of the overall package.

For non-recourse lending, the lender is generally looking at the income and assets of the SPV only in terms of repayment: but also may need certain assurances from the parent/sponsor reflecting that its borrower is a single purpose entity.

If such assurances are "guarantees" this would prevent section 431 applying to a fact-pattern directly within its purpose. Would it not be more appropriate for exemption to be still available in such circumstances, provided the guarantee does not have a financial value over a certain specified threshold? See for example the comments at section 431(5) below.

In addition to the general questions relating to the meaning of "guarantees" in relation to CRE finance, a specific question also arises in relation to the form of security arrangements a lender may want in place when lending to a SPV.

Assume the structure illustrated below, involving the single purpose companies Parent, Holdco, Mezzco and SPV, each of which should be capable of being qualifying infrastructure companies:



The lender may want share security over Holdco, granted by Parent. This charge represents security over the shares in a qualifying infrastructure company (and so within section 431(4)(c)) but at the same time it also represents security over the assets of a non-qualifying infrastructure company (as the shares represent assets of Parent; Parent is not a qualifying infrastructure company as it owns shares in companies carrying on general trading businesses).

As a result, a single element of the security package both satisfies and fails section 431(4). In substance the charge is about enabling the lender to have full recourse to the qualifying sub-group, by allowing it to (in effect) eliminate, on a default, all other persons with a potential economic and/or legal interest in the sub-group. Therefore could the legislation provide that such a "guarantee" will not disqualify a company from benefitting from the PBIE where, although it provides recourse to assets of a non-qualifying infrastructure company, the assets are shares within subparagraph (c)?

In addition, where within such a structure, the SPV may borrow both from a third party and intra-group. The intra-group lending may originate from Parent, with on-loans passing through the corporate chain on a broadly back-to-back basis to SPV.

The lender will take security over the rights of each creditor: for Holdco and Mezzco, this will be security over assets of a qualifying infrastructure company (and so should not affect the exemption). If however Parent lends to Holdco, and the lender wants security over Parent's rights as creditor (to ensure that, if it acquires Holdco on a default occurring, it does not assume a liability to Parent but instead has rights to the income/assets such loans represent), the lender is still ultimately looking to obtain recourse to the qualifying sub-group (in the same way that it would be if it took control of the shares in Holdco).

However, the creditor rights over which security is given would be assets of Parent and so outside section 431(4). Such an intra-group loan provides (indirect) access to the income and assets of the qualifying infrastructure company and so should not cause the PBIE to be lost.

Finally, in the context of multi-asset non-recourse financing (whether a standalone facility or as part of a securitised portfolio), the lender will generally look for cross-collateralisation as part of the overall security package. Each asset owning company will provide security over its asset; and that security will not only support that SPV's obligations to pay interest/repay principal, but also the obligations of all the SPVs (ultimately) to service the loan. Multi-asset non-recourse deals may involve property portfolios in more than one jurisdiction. Under these rules, a UK SPV within such a portfolio will not be able to benefit from PBIE because of that cross-collateralisation, because the other asset companies will not be qualifying infrastructure companies (because they are not fully taxed in the UK): even if all the other conditions are met.

In this context, would it be possible to allow the UK company to benefit from PBIE where the "other" financial assistance is because of the cross-collateralisation arrangements in circumstances (for example) where the provider of that financial assistance "would be "a qualifying infrastructure company" but for section 427(5)? This might if appropriate be restricted to companies within an EU member state/the EEA; and (perhaps) an equivalent "fully taxed on its income" requirement applied (instead of being taxable where resident, given that property is generally taxed in the jurisdiction where it is situated) to create comparability.

**Section 431(5)**: See general comments above. We agree with the comments of the BPF in section B of Appendix 1 to its submission.

How is "guarantee, indemnity or other financial assistance" to be interpreted? This links to whether a contractual warranty or undertaking (not giving rise to a financial right) would be caught: e.g. warranties as to corporate matters, which link to the lender being comfortable as to sub-group it is lending to, as opposed to being of financial value as such, may often need to be given by the sponsor or parent. In

addition, there could be similar requirements for certain parent company covenants on a securitisation (linked to rating requirements).

For example, on agency securitisations, the underlying asset-owning companies may have acquired properties intra-group as a precursor to the financing (an existing group company may have a commercial history, not being an SPV, so the relevant properties are transferred to a new SPV within the group so that, for rating purposes, there is limited risk of any unexpected/unknown liability). Such a transfer would usually benefit from group treatment (no gain/no loss for CGT and group relief for SDLT). The nature of those intra-group provisions means that there is a contingent liability to tax in the event of a de-grouping within a specified period.

For rating purposes, the risk of that contingent liability arising could be seen significant as it would give rise to tax without a cash receipt, and impact cash flows. The risk (as seen by rating agencies) is not one linked to a voluntary action as such, but more to do with what could happen as a result of action of an administrator over the asset company.

Market practice is therefore to enter into arrangements to create a disincentive to any administrator triggering the contingent gain: these involve undertakings not to de-group, supported by an indemnity from the relevant parent company (or companies) that are part of the relevant group relationship between transferor and asset company which is itself secured (with share security).

Which group companies are involved will be a function of the tax group rules, so may include non-qualifying infrastructure companies. These are not "credit" arrangements (the rating agencies will not ascribe value to the promise to pay provided by the indemnity) but rather a disincentive (because the security and the indemnity together would make an administrator less likely to act). However because there is an indemnity, there is a financial element in this. We would not anticipate that such arrangements should be caught: but the drafting here may mean that they are[4].

Further, where a company has elected under a relevant provision of tax law to transfer a liability to another group company (for example, within the capital markets arrangements/transfer pricing provisions) would that be "other financial assistance"? Again, we assume this should not mean that the PBIE is not available.

The impact of guarantees in lending is relevant to transfer pricing, where "guarantee" is defined broadly in section 154 TIOPA, but this only applies for the purposes of sections 152 and 153. There is guidance on guarantees within the International Tax Manual in relation to transfer pricing (INTM413110), which states that:

> "The presence of a guarantee does not necessarily signify a change in lending terms ... Lenders may seek guarantees as part of a "belt and braces" approach: not a crucial factor, but better to have than not have."

Given the existence of "belt and braces" approaches within the lending market, it is key that the meaning of this term as applied for section 431 is clear.

**Sections 432 to 436**: No comments.

[4] In 2007, the government was considering introducing regulations to allow a securitisation company to "transfer" a contingent CGT liability to another group company, following the approach taken on transfer pricing. However, the financial crisis meant that work on the Taxation of Securitisation Property Companies Regulations ceased.

## Appendix 2: Draft Finance Bill provisions – Other Comments

As stated above, we endorse the comments made by the BPF on the draft Finance Bill provisions. In addition, we set out below some further comments on particular aspects of the legislation, following section order. Our most important points relate to:

- the meaning of "related party" and ensuring that genuine third party lenders are not treated as "related" – a point that is relevant in the context of:
    - section 455 and the safe harbour currently available only to banks;
    - section 452 and the "market standard" guarantee (which should not of itself make a lender "related"; and
    - section 451 and the need for greater clarity as to the exclusion of rights under share security from "rights a person may acquire" until and unless they are exercised;
- the timing of the initial PBIE election for existing arrangements (paragraph 27 Schedule 1)
- the meaning of "commercial restructuring arrangements" within the TAAR (section 447)
- the treatment of a securitisation company's tax-interest amounts and tax-EBITDA for the purposes of the group ration where it is consolidated with its sponsor/originator group (section 402); and
- the treatment of results dependent interest payable to a UK corporate tax payer within the group ratio (section 410).

**Section 393(5)**: We do not consider it appropriate that a decision to submit an abbreviated return in a period (because circumstances allow that to be done) should then preclude any ability to have an interest allowance in that period. The compliance obligations under these provisions are heavy: it is understandable that a company may wish to avail itself of this option. At the very least, a company should be allowed to re-file a full return for the period to re-set an interest allowance. We agree with the comments made by the BPF in this respect on the draft legislation published on 5 December 2016.

**Section 402**: Legislation addressing the position of securitisation companies has yet to be published. The Responses Document states at paragraph 5.5 that a securitisation company's retained profit will be treated as tax-interest income to reduce the "administrative burden in analysing the retained profit".

It will be important that any measures dealing with securitisation companies recognise the manner in which they fall to be taxed under the Securitisation Regulations, taking account not only of the position of the securitisation company, but also that of any worldwide group of which it may be a member. (Although securitisation companies are generally established as orphan companies, the definition of group for the purposes of the interest restriction rules is by reference to IAS principles. As a result a securitisation company may be "grouped" with its originator/sponsor. For agency and whole business securitisations, an issuer or borrower may be a group company (in terms of ownership of share capital) in any event.)

In particular, in working out the tax-EBITDA of a securitisation company, it is important to recognise that its adjusted corporation tax earnings (as determined for the purpose of section 402) are therefore likely to differ from its "retained profit". This is because the effect of Regulation 14 is that the retained profit is brought into account for corporation tax purposes "instead of any other amount"; it does not "switch off" normal corporation tax rules (instead, normal corporation tax rules apply save as provided for in Regulations 15 to 21. See CFM72610 of the Corporate Finance Manual which confirms that:

> "Regulation 14(4) provides that the amount taxed under the securitisation regime is instead of any other amount that would be taxed. In other words, the normal tax rules that apply to the computation of a company's profits apply, but the amount actually taxed is in accordance with Regulation 14. ... For the purposes of making CTSA returns the company will simply substitute the profit arrived at under Regulation 14 for the normal tax-adjusted profit or loss per the accounts."

Given that the tax-EBITDA of each group member is taken into account to work out aggregate tax-EBITDA (under section 401), which is relevant to both the fixed ratio and group ratio rules, it needs to be ensured that the appropriate amount of tax-EBITDA (and "net" tax interest) of a securitisation company is taken into account when working out the position of the overall group under each of the fixed or group ratio tests.

Treating the retained profit as "tax-interest income" (as proposed in the Responses Document, and reflected in paragraph 244 of the Explanatory Notes) may not be sufficient for this purpose.

**Section 402(8)**: Should the reference to "subsection (8)" be to subsection 7)?

**Sections 407 and 408**: What is meant by "attempting to bring/alter"? We assume that this is intended to address the situation in section 329 CTA 2009; will guidance confirm (given the legislative approach differs)?

**Section 410(2)**: Should the reference here be to "qualifying net group-interest expense", not "adjusted net group-interest expense?

**Section 410(3)(b)**: We welcome the statement in paragraph 5.5 of the Responses Document that a securitisation company will not be subject to a downward adjustment for interest on results-dependent securities.

This reflects the fact that section 1015(4) is not relevant to securitisation companies so that interest on such securities can be brought into account for corporation tax purposes.

A similar principle applies to results-dependent securities generally where the creditor is a company within the charge to corporation tax (see section 1032 CTA 2010). Although, in practice, many such securities may be owned by related parties (given the practical impact of limited recourse on enforcement), third parties can also hold such securities. This is often the case, for example, on securitisations given rating criteria: although the Responses Document addresses the position of securitisation companies within the Taxation of Securitisation Company Regulations 2006, there are companies that are party to securitisations but not within those Regulations (for example, because they are taxed under the "interim" regime which has recently been extended).

We consider a downwards adjustment for such securities issued by a UK company should also be dis-applied, reflecting the fact that interest on those securities is deductible for corporation tax purposes. This would preserve the tax treatment of such securities where the lender is a true third party – in keeping with the policy underlying the group ratio rule: where such securities are owned by a related party, they would not qualify as an item of tax interest under the group ratio in any event because of subsection (3)(a).

**Section 440(10) (REITs)**: What is meant by "same nature"?

**Section 447 (Anti-avoidance)**: We welcome the inclusion of a safe harbour for "commercial restructuring arrangements", particularly in relation to the type envisaged by section 447(9)(b). We assume such arrangements would include restructuring a corporate sub-group so that a borrower meet the PBIE conditions.

In relation to CRE finance (and potentially finance more broadly), any such restructuring of a borrower sub-group is likely to require lender consent (given the nature of standard warranties and undertakings within CRE finance transactions). Where the loan has been securitised (whether as part of a conduit or agency transaction), that consent may need to be given by the trustee or servicer and also potentially the rating agencies. In practice, the benefit (in terms of increased certainty on cash flows) should mean consent is forthcoming: however, a lender/trustee would generally want to be assured that the restructuring will be effective. If a borrower restructures, only for the TAAR contained in section 447 to apply (reverting the borrower's tax position to one based on the fixed or group ratio), then the lender could potentially be in a worse position than it was before the restructure – particularly if the restructuring means that security arrangements have changed. In addition, where the restructuring involves assets (including shares) being transferred and new security given, that security will be subject to "hardening" periods (linked to solvency risks) in any event.

Further, where a group identifies that a restructuring is needed for certain existing subsidiaries to qualify for PBIE, it has a limited timescale in which to carry out that restructuring given the deadline for an election under paragraph 27 of Schedule 1. There is also the risk – as highlighted by the BPF in their submission – that a company could be subject to the new rules in full (i.e. ignoring PBIE) pending any restructuring being implemented. As a result, we would anticipate that borrowers would be looking for any consent from lenders to be provided within a relatively short timetable: and any questions about the efficacy of a restructuring could cause delays.

If, as the BPF notes, many groups need to undertake substantial restructuring exercises, lenders may find themselves the recipients of a significant number of requests for consent relating to detailed (and potentially complex) step-by-step restructuring plans involving both the release of existing, and the grant of new, security as well as changes in any guarantees which technically fall outside the scope of the limited PBIE "allowed" guarantees. There could therefore be a significant number of issues to be addressed: all of which would be redundant if the restructuring is disregarded under the TAAR.

It is therefore very important that guidance on this provision – and in particular on the meaning of "commercial restructuring arrangement" – is published as soon as possible after commencement of the interest restrictions.

The guidance should comment on when an arrangement would be accepted by HMRC as being "wholly consistent" with the policy objectives underlying a relief, and also what is meant by "ordinary commercial steps" and "generally prevailing commercial practice". One or more worked examples relating to the PBIE would be helpful, and ideally HMRC should confirm its willingness to provide non-statutory clearances to taxpayers on this aspect of the rules in particular. As stated above, the non-recourse nature of CRE finance means a lender needs a high degree of certainty in expected cash flows. By allowing groups to restructure to fall within the PBIE, the government recognises the importance of such certainty for certain sectors (including CRE). It is therefore important that HMRC practice (in terms of guidance and non-statutory clearances) supports this policy objective fully, thereby facilitating in practice the type of restructuring that this exception to the TAAR is intended to permit.

**Section 449(2)**: The adoption of an accounting based consolidation test for related parties, although understandable within a regime heavily based on accounting concepts and relationships, broadens the test beyond that which has generally been used for tax purposes. However, there is no equivalent as such within the OECD best practice recommendations (which looks at related parties as determined by "effective control" (i.e. the transfer pricing test) and 25% investment). Is "consolidation" needed as an additional limb?

(Relevantly, in the context of securitisations, consolidation means that an orphan securitisation issuer is seen as "related" to its sponsor (bank or other lender) even though there is no other relationship within the rules. A securitisation company within the Taxation of Securitisation Companies Regulations should

not itself be impacted by these provisions (as per the Responses Document). But for securitisation companies within the interim regime that are conduits and so similarly consolidated, any financing provided by the sponsor (liquidity, derivatives, retained notes to meet regulatory requirements) will be related party debt and outside the group ratio, even though there is no effective "control").

In any event, within subsection (2), it would be helpful to understand how this test works where an ultimate parent has optionality around accounting, so that there is "no requirement" and "no exemption". There are also situations within the rules where a departure from accounting consolidation is permitted. In relation to funds, there is the provision that excludes subsidiaries held at fair value from being consolidated (see s459). How do these provisions interact with section 449(2)'s consolidation requirement which appears to apply a different test?

**Section 450(1)**: As we said in our comments on the May 2016 Consultation on design and delivery of the new interest deductibility provisions, it is important that security rights conferred on a third party lender should not themselves be taken as conferring any form of equity stake (or entitlement to acquire an equity stake) unless and until those rights are exercised.

**Section 450(3)**: The disregard for banks lending in the ordinary course should apply to other types of "ordinary course" lender as well (see further comments on section 455).

**Section 450(5)**: Where amounts are to be apportioned between partners under these provisions, we assume that a "just and reasonable" basis would require any apportionment to reflect the commercial agreement between the partners themselves?

**Section 451(5)**: Should the reference to "managing person" be specifically linked to the person referenced in subsection (4) for clarity?

**Section 451(9)**: As we said in our comments on the May 2016 Consultation on design and delivery of the new interest deductibility provisions, it is important that security rights conferred on a third party lender should not themselves be taken as conferring any form of equity stake (or entitlement to acquire an equity stake) unless and until those rights are exercised. The meaning of "may" in this context should be clarified.

**Section 452**: What is meant by "guarantee, indemnity or financial assistance" in this context? (See also our comments on the PBIE). As we set out in our comments on the May 2016 Consultation on design and delivery of the new interest deductibility provisions, it is important that standard security arrangements are not regarded as guarantees.

In addition, this provision should be limited to those situations where the guarantee means that the loan is in effect back-to-back (and so equivalent to the indirect loan relationship arrangement described in subsection (4)) and guarantee construed narrowly in that context alone. A "related party" loan relationship is excluded when applying the group ratio: true third party debt that benefits from commercial and market standard guarantee/arrangements (and are not disguised related company lending arrangements through a third party intermediary) should be capable of being taken account of in the group ratio.

If a guarantee is provided that renders the amount of debt "excessive" as compared to the amount that would have been lent absent that guarantee, a transfer pricing adjustment will be made – which should therefore reduce tax-interest expense in any event. Unless absent the guarantee the loan would not have been made (the type of arrangement the Explanatory Notes indicate this is directed at), it should be taken into account as third party debt.

**Section 453**: Given the nature of the main related party tests (including the new 25% investment condition, as extended by the "acting together" provisions in section 451) is this provision needed? It adds a significant amount of complexity: in practice, this seems directed at private equity type arrangements where investors fund equity and debt together. If this is the case, is it possible to consider whether the

main test would apply in such a situation – i.e. what situations does this cover that would not be picked up elsewhere?

**Section 454**: We welcome the policy rationale behind this provision. However, in practice, there will need to be clear guidance as to how this is to apply to standard commercial arrangements.

A loan may be advanced by a lead bank, and then syndicated. In that context, each bank lender is party to a (separate) loan relationship for the purposes of CTA 2009. How does this provision apply? At the time the loan was advanced, there was a singe loan relationship as between bank and borrower. As syndication arises, new lenders acquire rights as against the borrower (through novation generally so that new relationships are created), each new lender acquiring at a different time. There could then be subsequent transfers of participations during the term of the loan. Is this provision is intended to apply as if the overall lending arrangement at day one is the "loan relationship" and each bank is a relevant creditor, or is reliance placed on section 454(1)(c) – if so, how does "the same time" apply?

A loan may be tranched: with the same or different banks advancing a tranche. Are such arrangements intended to be within subsection (1)(c) (we assume the reference to "other loan relationships" means other loan relationships with D – is that correct)? Given section 454(1)(e), such loans – which are in effect part of the same overall arrangement (sharing security, etc.) would carry different rights (linked to coupon) and so would not seem to be within limb (c). What is meant by "same rights" – the legislation states what will not be regarded as same rights, but does not comment on what "rights" means.

A loan may be advanced as a single loan, and then on syndication, the agent bank in effect "tranches" the loan, but that tranching is operative between the lenders only (the borrower may not be aware of the arrangements between lenders). We assume that section 454(1)(e) would be met in this context because any differences in rights are not between debtor and creditor(s). In this context, does section 454(3)(b) apply – and if so how?

If a loan has a guarantee that means section 452 applies, then section 454 can never act as a safe harbour it seems: is that correct? See our comments on section 452 in this context.

In relation to subsection (3)(a) standard terms in a loan would include (for example) a tax gross up. This is a standard provision that applies to all lenders, but the effect of that provision means that it may have (is capable of having) different effects for different people depending on their status for tax purposes. Is it right to assume that this type of provision is not within the scope of this subsection: in that it treats the "same type" of person (i.e. treaty lender/bank lender) the same way (so such are not "different" within subsection (4)(c))?

How is subsection (3)(c) to be interpreted?

Finally, how is a borrower to know if the 50% condition is met: should this be subject to a "reasonable belief" type condition? Within a facility agreement, a borrower should know the identity of each lender of record (through the transfer certificate process); however if the loan relationship is in the form of securities (for example, bearer securities are common on the international capital markets), a borrower will not have that information.

**Section 455**: The Explanatory Notes state that this provision is intended to apply where the loan is made by a bank in the ordinary course of its banking business "and the decision of the bank to lend the money was made without regard to the interests which made the bank a related party."

This is not what the legislation provides. Instead it focuses on whether the bank was aware/could reasonably be aware of such interests.

A bank can make a loan in the ordinary course to a business that it is related to on terms that are not impacted by that relationship (i.e. the loan is subject to the same credit assessments as a loan to a "true" third party). We see no reason why such a loan should not be third party debt. For example, bank sponsors of securitisations will often provide liquidity and other facilities to the (orphan) securitisation vehicle. The bank will be related because of consolidation where the vehicle is a conduit. The relationship will be something the bank is aware of. For securitisation companies not within the permanent regime, this provision seems to mean that such commercial arrangements will be related party debt.

In particular, as this links to the bank's awareness, what basis will the borrower have for knowing what its lender could or could reasonably be expected to be aware of, when determining if its loan is "third party" or "related party" for the group ratio?

Perhaps most importantly, the focus on banks alone is problematic. Although the CRE sector has historically sourced third party debt finance mostly from the banking sector, over recent years, the UK CRE debt market has diversified. This is a healthy development that disperses financial stability risks that were concentrated within the banking system before the global financial crisis. It is also good for borrowers, because a wider range of lender types increases the range of debt products available and reduces the risk that the whole market turns supply on or off at the same point in the cycle. There are now a range of new lenders (including insurance companies and pension funds) and new vehicles for non-originating capital providers (including debt funds – or direct lending funds as referenced in the carried interest legislation). Investors in such vehicles include institutional investors. Such investors may have, within the overall group of which they are part or as a result of ownership of investments in funds) equity investments within potential borrower companies – but in circumstances where the person/group making the decision to lend "could not reasonably be expected to know". Limiting this particular safe harbour to banks does not take account of the lending landscape in the 21st century. It should be extended to other types of "ordinary course" lenders.

A similar point arises with respect to section 450(3): entities other than banks lend "in the ordinary course" within the CRE sector and so should similarly be provided for.

**Section 475**: We welcome the inclusion of a regulation-making power to enable (in effect) a securitisation company to elect a tax liability arising from an interest restriction to another group company.

**Schedule 1**

**Paragraph 23 (Commencement)**: See "Key Comments – Transitioning to the new rules: timing and grandfathering" above.

**Paragraph 26 (Special "Disregard" election for derivatives)**: CRE finance is usually provided on floating rate terms, with borrowers often entering into derivative contracts to "fix" their interest expense. The ability to elect to (in effect) apply the Disregard Regulations for the purposes of the interest restriction provisions is therefore welcome. However we consider that, given that any such election has to be made by all companies within a worldwide group, the deadline for making such an election should be extended (to, say, two years after commencement of the rules) to allow groups to assess the impact of such election fully. After all, the effect of such an election cannot be determined without having first considered the impact of the rules in general, and the various options/elections provided for to ameliorate potential unintended consequences.

Guidance should clarify how this interacts with section 415 (Derivative contracts subject to fair value accounting). In addition, we agree with the BPF that the government should clarify why this election only applies to derivatives entered into pre-2020 (see Appendix 5 of the BPF submission).

**Paragraph 27 (PBIE election)**: The deadline for making such an election in respect of an existing borrower should be extended to allow groups to assess the impact of such election fully (noting that the effect of such an election cannot be determined without having first considered the impact of the rules in general, and the various options/elections provided for to ameliorate potential unintended consequences. For accounting periods ending on or before 31 December 2017, we consider a more appropriate deadline would be within 12 months of end of the company's accounting period.

In addition, as set out in our comments on section 447, if a group needs to restructure its business so that particular companies can fall within the PBIE, in the context of CRE finance in particular, it is very likely that such a restructuring of a borrower sub-group will need lender consent (given the nature of standard warranties and undertakings within CRE finance transactions). Where the loan has been securitised (whether as part of a conduit or agency transaction), that consent may need to be given by the trustee or servicer.

In practice, the benefit (in terms of increased certainty on cash flows) should mean that lender and borrower interests are broadly aligned. But a lender/trustee will still want assurance that, from a credit perspective, its rights are not adversely affected by the restructuring. This will particularly be the case if the restructuring involves the release of existing security and/or changes in any guarantees which technically fall outside the scope of the limited PBIE "allowed" financial assistance. There could therefore be a significant number of issues to be addressed: all of which will take time to work through (by the lenders and their own counsel).

If, as the BPF notes in Appendix 1 of its submission, many real estate groups need to undertake substantial restructuring exercises, lenders may find themselves the recipients of a significant number of requests for consent relating to detailed (and potentially complex) step-by-step restructuring plans.

As a result, even if a borrower group on a standalone basis is able to identify and implement the steps needed within the period currently allowed by the legislation, the need for lender consent could itself lead to delay – and hence we agree with the BPF that a longer period is needed.

Finally, we share the views of the BPF concerning relating to the "Transitional Period" in Part H of Appendix 1 to their submission: in particular, asking for the PBIE tests for an existing company to be relaxed for an initial period after commencement, given the possible need for some groups to restructure to fall within the PBIE criteria. The policy objectives underlying both PBIE (and additionally the commercial restructuring safe-harbour within the TAAR in section 447) would not be achieved if a company, because of the need to restructure, is precluded from PBIE whilst that restructuring is carried out.

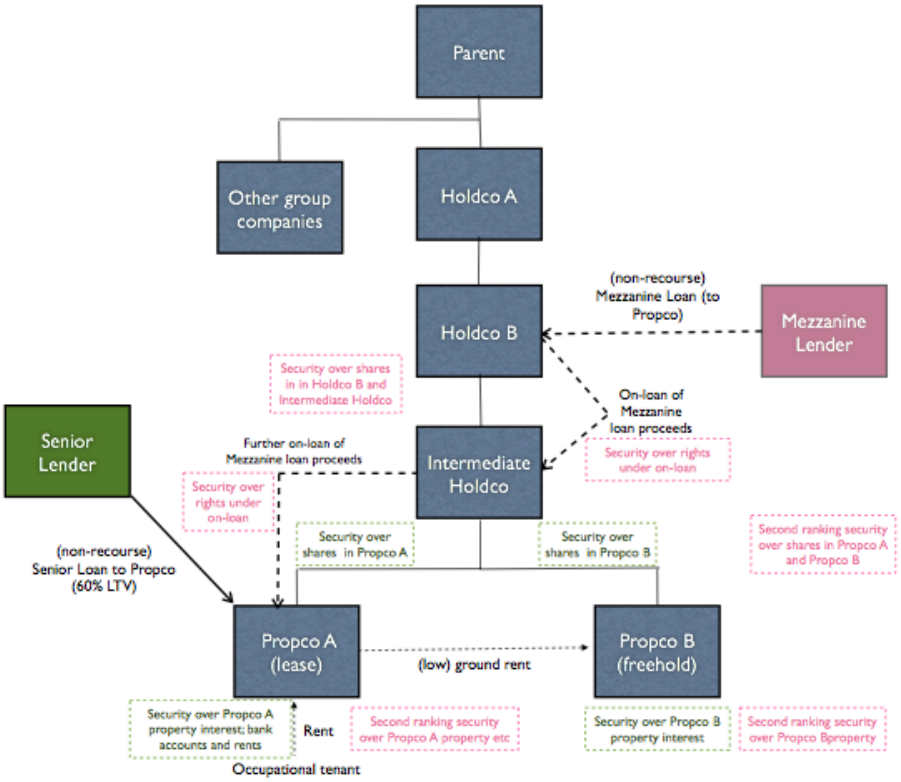
# Schedule 1: Non-recourse debt

## A. General

CRE financing structures tend to involve non-recourse debt. The term "non-recourse" recognises that, on enforcement, the CRE lender's recourse is to a specific asset, as opposed to the position under general corporate lending, where the lender will generally have recourse to the borrower's entire group undertaking. Guarantees and cross-collateralisation are not unknown (indeed in specific parts of the market they can be common), but under the standard CRE finance model, the lender takes risk solely on the relevant asset and its cash flows, and has no recourse other than to SPVs holding that asset (whether directly, by way of asset level security, or indirectly, by share charges over the share capital of those SPVs).

## B. Example of a non-recourse financing structure

The diagram below shows a typical CRE financing structure and incorporates both senior and mezzanine financing.




The diagram shows that the senior lender will typically lend directly to the property-owning SPV. In the event of a default, the senior lender will want to be able to take control of the property. The security package reflects this, enabling the lender to take control of all the interests in the property within the group (hence the share and asset level security over Propco A and Propco B, even though the value – i.e. the property interest that is directly reversionary to the occupational lease – is in Propco A).

The mezzanine lender lends at a different level in the structure to ensure that it cannot interfere with (and thus potentially impede) the exercise by the senior lender of its rights).

In the event of a default, the mezzanine lender will want to take control of those parts of the structure through which its rights to the property held by Propco A (and the income from that property) are traced.

Hence in addition to (second ranking) security over Propco A and Propco B, it takes security over the relevant intermediate holding companies and the intra-group loans they make. All these companies are single (or special) purpose vehicles, and neither the senior nor mezzanine lender will have any recourse beyond the security rights over (and covenants given by) this sub-group – i.e. there is no recourse to the broader corporate group.

## C. What is non-recourse financing?

***(1) Bank regulation: Characteristics of CRE finance as a specialised lending exposure***

For bank regulatory purposes, typical CRE finance is seen as a specialised lending exposure. Its regulatory treatment can be (and currently is, for the large UK banks) different from that applied to general corporate lending, reflecting the different risks and benefits that arise to a lender providing finance on a non-recourse basis. Risk weightings can range from 50% to 250% for such lending, depending on various factors, including the asset characteristics and the nature of the security package. The risk weightings for such specialised lending differ from (and are typically higher than) those available to general corporate loans.

The FCA Handbook identifies as a specialised lending exposure one that has three specific characteristics[5]:

A. the financing (and as result the exposure of the lender) is to an entity which was created specifically to finance and/or operate physical assets;

B. the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate; and

C. the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise.

***(2) How does CRE finance reflect these characteristics?***

Applying these characteristics to a standard CRE financing structure (of the type illustrated in the above diagram):

(a) The borrower is a single (or special) purpose corporate vehicle that owns the property/properties being financed, but carries on no activities other than the operation of that property business. This means that, as a practical matter, the only assets and income available to that borrower to service the loan are the property/properties it holds and the rental income arising therefrom.

(b) The terms of the financing contain representations, undertakings and covenants relating to both the borrower SPV (its corporate and legal status and the activities it carries on) and the property being financed (such as details of ownership, letting parameters and other aspects of property management, including maintaining appropriate insurance and restrictions on disposals or certain other dealings with the property).

(c) The financial covenants and undertakings generally relate to (a) interest and debt cover (a ratio that compares payments under the loan to the amount of rental income received on the property and (b) loan to value, capping in effect the principal due under the loan to a particular percentage of

[5] See BIPRU 4.5.3

property value, providing the lender with assurance that the value of the collateral (the property) exceeds the amount owing by a certain margin[6].

(d) Interest on the loan is funded out of rent (hence the importance of the interest cover ratio). The loan may also provide for (limited) amortisation to be funded out of rent.

(e) To repay the loan, the borrower SPV will look to either refinance or alternatively may look to sell the property and repay out of the proceeds of sale (hence the importance of the loan to value covenant).

(f) The security package will include a mortgage over the property (allowing the lender to appoint a Law of Property Act receiver over the property in the event of a default) and security over the bank accounts of the borrower into which rent and other income of the property is paid). The loan will include controls over the bank accounts that are set up by the borrower SPV: effectively restricting the payments and transfers that can be made out of the accounts.

(g) In addition, the lender will generally have share security over the shares in the borrower SPV (granted by its parent company) so that, should there be an enforcement event, the lender can choose whether to take direct control the property (by appointing a Law of Property Act receiver) or instead to take control of the borrower SPV itself.

(h) The loan may include a statement that confirms that, in the event of enforcement, the lender acknowledges that its recourse is to the borrower SPV, and the assets over which it has security only – and in particular the lender has no recourse against shareholders, directors or any other member of the corporate group.

In effect, the nature of the recourse given to a CRE lender – namely, to the underlying assets and their cash flows only – is similar to the position summarised in the Consultation concerning "eligible loans" potentially within the public benefit infrastructure exemption (see the third bullet under paragraph 7.8 of the Consultation): indeed, project finance is another type of specialised lending exposure for financial regulatory purposes.

[6] CRE loans will often include financial ratios directed at (a) rental income (interest cover and/or debt service) and (b) property value (loan to value), rather than EBIT/EBITDA-based ratios, reflecting that they are a form of asset financing. It would be rare for a CRE loan (or associated financial modeling to focus on EBITDA. This is because the typical CRE loan is asset finance, not corporate lending.