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VAT Grouping – Establishment, Eligibility and Registration: Call for Evidence

Response of the Commercial Real Estate Finance Council (CREFC) Europe

The Commercial Real Estate Finance Council (**CREFC**) Europe is a trade association promoting a diversified, sustainable and successful commercial real estate (**CRE**) finance market in Europe that can support the real economy without threatening financial stability. Our membership includes a range of different bank and non-bank lenders, intermediaries and advisory businesses, and real estate firms that use debt to finance their activities.

In responding to this call for evidence, we have focused on Chapter 2: Compulsory VAT grouping and the questions set out in that Chapter. We have also engaged with the British Property Federation (**BPF**) and the Loan Market Association (**LMA**) whose draft responses we have seen and generally support.

Headline response

Within the UK, CRE finance is generally provided by way of non-recourse secured lending which enables finance to be provided on competitive terms. Such financing arrangements, which mean that the lender's recourse is limited to the collateral provided by the borrower, require the borrower to be effectively 'ring-fenced' from credit risks that could arise elsewhere in the corporate group of which the borrower is a member.

Those credit risks include the potential for joint and several liability for VAT within a VAT group. Currently, because VAT grouping is optional, this credit risk does not arise as the terms on which CRE finance is provided will prohibit membership of a VAT group. Compulsory VAT grouping would mean that the borrower could no longer be 'ring-fenced' from that risk, with negative credit implications. We would expect the supply of credit to the UK CRE industry to become less flexible and more expensive as a result.

We therefore agree with the BPF that compulsory VAT grouping should not be introduced.

General: CRE Finance and VAT grouping

Our responses on questions relating to whether VAT grouping should be compulsory link to the basis on which lenders generally finance investment in CRE within the UK. A strength of the UK legal and commercial environment for CRE investment is that income-producing real estate can be (and typically is) financed on the basis of a secured, non-recourse loan made to a special purpose vehicle (**SPV**) that owns the real estate. This approach allows a lender to underwrite the risks, cash flows and prospects of the real estate collateral, without needing to understand all the risks associated with the borrower organisation's wider business. From the borrower organisation's perspective, it allows finance to be raised in a way that limits the downside to the real estate collateral: the lender is not given recourse to the assets or cash flows of the wider business to support the secured loan. For this to work, it is important that the SPV is not exposed to potential liabilities arising elsewhere in the borrower's group (such as would unavoidably arise with compulsory VAT grouping). The following paragraphs provide a little more detail.

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. Under a standard CRE finance model, the lender takes risk solely on the relevant CRE asset and its cash flows, and has no recourse other than to the company holding that asset (whether directly, by way of asset level security, or indirectly, by share charges over the share capital of that asset-owning company). As a result, the primary source of repayment under the financing is the income generated by the underlying property. The model is therefore focused on the level of, and access of the lender to, that income.

Secured, non-recourse lending is also recognised by financial regulation. This kind of financing of income-producing real estate is a "specialised lending exposure" as described in the Basel framework and FCA Handbook, and carries different risk weightings from those applicable to general corporate loans. In particular, a characteristic of this form of lending is contractual arrangements that give the lender a substantial degree of control over the CRE asset and its income.

Under the standard CRE finance model, the financing arrangements seek to limit the risk of (unexpected) claims of third parties which could mean that the income generated by the real estate collateral is not in fact available to service the loan. To that end, the terms of a non-recourse CRE financing will 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).

In the interests of maximising the predictability of cash flows, those representations, undertakings and covenants also cover matters relating to VAT. In particular, given the obligation to account for VAT to HMRC where supplies of the property are subject to VAT at the standard rate – whether because of the nature of the property or because an option to tax has been made – the finance arrangements (particularly the account structure and payment waterfall) will look to ensure that the borrower has funds available to meet VAT when due. Requirements for the SPV to have no other assets, liabilities or activities help ensure (among other things) that the amount of that VAT is readily quantifiable.

These representations, undertakings and covenants also address VAT grouping. The lender will require the borrower SPV to confirm it is not, and will not become, a member of any VAT group whilst the loan is outstanding.[1] The principal reason for that restriction is that membership of a VAT group results in joint and several liability for amounts due to HMRC in respect of supplies made by all the members of that group. If the representative member were to default in its responsibilities in relation to VAT, then it would be open to HMRC to look to the borrower SPV to pay VAT owed in relation to <u>all</u> group activities, not just its own. As a result, the lender could not be sure that income generated from the property would be available to service the loan (and other predictable liabilities arising from the real estate asset owned by the SPV). Indeed, because the amount that could be diverted to meet VAT group liabilities is dependent on the activities of all members of the VAT group at the relevant time, the potential financial liability would be unquantifiable, and the whole premise of secured, non-recourse lending would be undermined.

Even if, as part of any change to compulsory VAT grouping requirement, HMRC agrees to look to each member of the VAT group to account only for its own VAT in the event that the representative member defaults (whether as a matter of practice or amendment to the current rules), it is likely that the delay between default and HMRC action to recover that VAT would mean that any VAT due would cover more than just the current period – resulting in a potentially significant debt owed to HMRC, impacting the funds available to service the loan.

[1]For completeness, it should be noted that if multiple borrower SPVs are party to the loan (as will be the case under a portfolio financing), then the lender may agree to allow those borrower SPVs to be members of the same VAT group, but would prohibit any company that is not itself providing security in respect of the financing from being a member of that VAT group. This is because the lender is (in credit terms) exposed to each of the relevant companies in any event and so may be willing to accommodate any borrower request to have a single company responsible for VAT compliance.

By prohibiting membership of any VAT groups, the lender can be comfortable that the borrower SPV is responsible only for its own VAT compliance with reference to the supplies it makes – and can be confident that payment of that VAT will not impact loan service.

In addition, if the borrower SPV has not itself opted to tax the property that forms the collateral for the loan, but another group member with an interest in that property has, compulsory VAT grouping would result in the property being deemed to be opted under the "relevant associates" provisions. This again could have the effect that a proportion of income generated from the property would not then be available to service the loan (this is because, as the borrower SPV had not opted, any leases it had granted may not have been granted on VAT-exclusive terms).

If VAT grouping was compulsory, a CRE lender would need to assess and evaluate the resulting financial risks – and take them into account in assessing the availability and terms (particularly pricing) on which a loan is advanced given their potential negative credit implications. We would expect the supply of credit to the UK CRE industry to become less flexible and more expensive as a result.

Responses to specific questions in Chapter 2

Question 16: What benefits or disadvantages could a system of compulsory VAT grouping deliver for businesses? Would this vary between different sectors?

As described above, the terms of non-recourse CRE funding restrict borrowers from joining a VAT group given the financial implications (in particular) of joint and several liability. For existing borrowers, compulsory VAT grouping could therefore result in the borrower SPV breaching one or more loan covenants, potentially triggering an event of default (though this will depend on the specific terms of the loan – for example, whether there is a materiality threshold or an "unless required by law" exception).

In any event, the borrower SPV would need to notify the lender who may as a result look to make changes to the loans to reflect the new risk profile.

For new borrowers, the credit implications of the risks associated with VAT grouping would need to be taken into account in assessing the availability and terms (particularly pricing) on CRE finance. It is likely that the very broad, efficient and cost effective use of secured, non-recourse SPV financing for real estate assets would be negatively impacted, restricting the financing options available to those acquiring or owning commercial buildings.

Additionally, we note the response of each of the BPF and the LMA to this question, which we support.

We note that similar issues would arise for other sectors that access non-recourse financing, such as infrastructure and project financing.

Question 17: How would compulsory VAT grouping impact the administrative processes for businesses?

We note the responses of each of the BPF and the LMA to this question, which we support.

Question 18: How would compulsory VAT grouping interact with 'establishment only' VAT grouping provisions, if they were to be implemented?

No comment.

Question 19: How would compulsory VAT grouping impact businesses of different sizes, and would the minimised risk of errors be of benefit?

See answer to question 16.

Question 20: Are there any instances where businesses are not VAT grouped for specific commercial or regulatory reasons? Please provide examples.

As discussed above, across the real estate sector, secured, non-recourse finance is common, both for construction projects and assets that are already income-producing. With the lender taking risk solely on the relevant CRE asset and its cash flows (with no recourse other than to the company holding that asset), the finance arrangements seek effectively to ring-fence the borrower SPV from risks elsewhere in the corporate group of which it is a member. This approach is popular with both borrowers and lenders, offering a flexible and cost effective alternative to normal business loans. The main group-related tax risk arises from VAT groups (generally, other than in relation to VAT, there is no general joint and several liability under tax rules). Compulsory VAT grouping would run counter to the standard lender requirement for the borrower SPV to represent and undertake that it is not, and will not become, a member of a VAT group whilst the loan is outstanding.

Compulsory VAT grouping would also be problematic in the context of commercial mortgage-backed securities (**CMBS**) where the assessment of the securitisation issuer's ability to meet its payment obligations under the notes it issues to investors is based on the availability of funds within each underlying borrower SPV to meet its obligations to the issuers. As a consequence, the standard lender requirement for the borrower SPV to represent that it is not, and will not become, a member of a VAT group whilst the loan is outstanding is of even more importance where the loan may become part of the collateral for CMBS. Compulsory VAT grouping of a borrower SPV would undermine the effective ring-fencing of that borrower and thus the analysis undertaken by credit reference agencies when determining, and monitoring, the appropriate credit rating for the issuer.

If you have any queries in relation to this submission, please contact me on 07931 588451 or pcosmetatos@crefceurope.org.

Yours faithfully,

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