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BPF and CREFCE response - Deduction of income tax from payments of yearly interest: private placements

Introduction

The British Property Federation (**BPF**) is the voice of property in the UK, representing businesses owning, managing and investing in property. This includes a broad range of businesses comprising commercial property developers and owners, financial institutions, corporate and local private landlords and those professions that support the industry.

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 members include lenders and intermediaries who help connect capital seeking the risk and returns of CRE debt with property firms seeking finance.

We are grateful for the opportunity to comment on these proposals, which offer a valuable opportunity to increase the role of private placements as a source of finance for critically important sectors of the UK economy. We are aware that certain of our comments relate to the primary legislation, for which the comment period has closed – however, they are important enough that we hope they can nevertheless be taken into account in developing these proposals.

Background

The functioning of business in the wider economy relies on investment into CRE. It provides high quality accommodation for businesses and allows them the flexibility to adapt and relocate with changing economic conditions.

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. That is especially so outside the prime central London market to which so much international equity capital is drawn. The UK CRE industry has historically sourced debt finance mostly from the banking sector. Indeed, during the last CRE boom the bulk of that finance was procured from a relatively small number of systemically important banking institutions.

When the CRE market went into sharp decline, many banks suffered significant losses or delays in recovering principal lent because borrowers were unable to sell or refinance their assets. That exacerbated the unavailability of new credit for the economy at large during the crisis, just when it was most needed, and despite the fact that investments (equity or debt) made at that point in the cycle often perform very well.

In the last year or two, CRE lending has finally recovered well, with strong supply both from the banks and from a range of new lenders and new vehicles for non-originating capital providers. We believe the current diversity in the UK CRE debt market is to be welcomed and should be supported. If it proves cyclical and banks re-establish their traditional dominance, a great opportunity to enhance the structural resilience of both the UK banking system and the supply of credit to the economy will have been missed.[1]

A competitive UK private placement market for CRE debt could contribute to greater structural diversity, both for investors seeking exposure to CRE debt, and for CRE businesses seeking finance. Institutional investors would benefit from the ability to gain exposure through privately placed bonds, without needing to build or acquire a CRE loan origination platform. The UK real estate industry would benefit from greater choice in raising finance and reduced reliance on the banking sector.

We are concerned that some of the proposed conditions of a qualifying private placement are needlessly restrictive and likely to all but exclude CRE finance from the proposed beneficial withholding tax treatment. The conditions we consider to be most restrictive are listed below; with further details included in the appendix.

Key points

- We are very supportive of this initiative to reduce the tax impediment to the UK private placement market. In our view, **any measures which will foster greater diversity in the UK lending market are a step in the right direction**. The opportunity to achieve this policy goal for the CRE financing market as well should be seized.

- The condition for the borrowing entity to be a trading company is the most problematic condition for the CRE industry, because CRE borrowers are commonly investment rather than trading businesses. We understand that this condition is also likely to be problematic for many (post-construction) infrastructure financings and even for SMEs (as finance would often be raised by a non-trading group company). As it is also unclear what purpose the condition serves in policy terms, **we recommend that the trading company condition is removed.**

- The legislation proposes to restrict the issuance by an individual company to £300m. While this will no doubt be sufficient for some businesses and in some industries, it seems unnecessarily restrictive from the perspective of the CRE industry, as indeed we are sure it would be in the context of infrastructure projects as well. **We would recommend significantly increasing or removing the issuance cap for an individual company.**

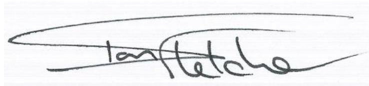
[1] We would draw your attention to *A Vision for Real Estate Finance in the UK*, a report published in May 2014 by an independent group of individuals drawn from across the UK property industry, available at http://www.ipf.org.uk/industry-involvement/a-vision-for-real-estate-finance-in-the-uk.html. The report makes a number of recommendations for reducing the vulnerability of the banking and wider financial system to the property cycle. One of those recommendations emphasises "*the important role that can be played in promoting financial system resilience and stability by diversity of lender response (principally through diversity of lender types and lender strategies, and with a focus on the role secondary markets can play)*". The report recommends that "*regulatory action should have regard to levels of diversity and seek to reduce barriers to entry, particularly for new or under-represented types of lender*". Encouraging the use of the private placement regime for CRE debt would be consistent with that recommendation.

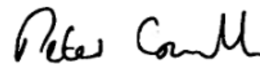
- The legislation applies to securities with a maturity of between 3 and 30 years. However, members tell us that maturities as short as 18 months may be suitable for private placement. In the absence of a compelling reason for imposing a minimum of three years, **we recommend removing the minimum maturity period, or at least reducing it to 18 months.**

- It is important that this proposal is implemented in a way that is workable in practice. In particular, **the operation of conditions and any certification regime must give issuers adequate certainty regarding the availability of the exemption.**

- We welcome the recognition in paragraph 2.4 of the consultation that certain conditions of the security, lender or borrower may need to be adapted as the UK private placement market develops. To that end, **it is important that the further conditions can be specified by regulation**.

We would welcome the opportunity to discuss the contents of this submission in more detail. We remain at your disposal should you have any questions or require further details.





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Appendix 1: Conditions which restrict the application of the legislation to real estate businesses

Conditions applying to the borrower

We are concerned that the condition for the borrower to be a trading company is problematic and unnecessary. Given withholding tax is a means of accounting for tax for which the lender is liable, it is not clear what the benefit would be of applying restrictive conditions on the borrower. Indeed, the more restrictive the conditions are, the smaller the number of businesses that will be able to benefit from the improvements to the UK private placement market.

The trading company requirement is likely to be problematic for the two types of business the proposals are explicitly intended to benefit. First, for many infrastructure projects trading status will often be uncertain after the construction phase is complete. Secondly, SME groups might naturally prefer to use a non-trading group company to raise finance.

The requirement for the borrower to be a trading company would also restrict many real estate businesses form making use of this legislation and would result in some inequitable distinctions between different companies undertaking the same activities. For example, a corporate property developer holding real estate on trading account would benefit, but one that holds property and develops it as an investment would not. Both need finance to meet construction costs, but only one business would enjoy improved access to the private placement market. We recommend that the trading company condition be removed.

In respect of the requirement for the qualifying entity to be a "company"; we are concerned that this would restrict numerous UK businesses from qualifying. For example, a recent report of the Office for Tax Simplification notes that 10%[2] of UK businesses are actually structured as partnerships.

In the real estate context, properties are often held in non-corporate collective investment or joint venture vehicles, such as partnerships or unit trusts. The most neutral and effective way of allowing the real estate industry to benefit from the exemption would be to extend it to non-corporate entities (provided that their partners/owners are subject to UK tax on their share of the income arising in the partnership/other entity).

If Government have concerns with respect to allowing non-trading companies and certain non-corporate entities (such as partnerships) from making use of this legislation, we would welcome the opportunity to work with Government to understand and address these concerns.

Conditions applying to the security

The legislation proposes to restrict the issuance by an individual company to £300m. That may be perfectly adequate for some borrowers in some industries. However, it seems a surprisingly low cap for a measure intended to support infrastructure finance, and it would also be uncomfortably low for many CRE borrowers. As such, we recommend significantly increasing or removing the limit on the amount of issuance by an individual company. Based on member feedback, we also suspect that

[2] Office for Tax Simplification: Review of Partnerships, January 2015

the minimum issuance of £10m would deny the benefits of the proposal for smaller SMEs seeking to grow. We therefore recommend lowering or removing the minimum threshold.

The conditions apply to securities with a maturity of between 3 and 30 years. We understand that both the upper and lower cap could be restrictive. Long dated finance is common in, for example, the world of housing associations and may also be important to the emerging institutional private rented sector. We are not clear what the benefit of imposing such a restriction would be and as such, we recommend removing both the upper and lower cap. If Government are concerned about removing the caps completely, we would suggest reducing the minimum maturity period to 18 months.

If Government have any concerns around amending the conditions on the security in respect of the issuance amounts or maturity periods at this stage, we would welcome a discussion on the subject, or a commitment to reconsider these conditions after the regime has been in operation for a period.

Conditions applying to the lender

It is not clear what type of entities constitutes "UK regulated financial institutions". We would expect and hope that pension funds and insurance companies would qualify but it is important for Government to provide clarity in this regard. The universe of lenders and debt investors has been rapidly expanding in recent years – a welcome trend for the resilience of both credit flow to the real economy and the banking system. Subject to addressing specific concerns around protecting the Exchequer, we would therefore recommend the widest possible definition with a view to ensuring that the exemption has the maximum impact in this evolving and diversifying market.

Once a lender has been certified as qualifying (as suggested under 3.10 of the consultation), it is important that the borrower is able to rely on this certification absolutely in order for them to have certainty over the tax treatment of the interest payments. If the certification was found to be untrue at any point, the remedy of HMRC should be on the lender and not the issuer. Bonds are less able to accommodate risk allocation based on representations, warranties and indemnities between the parties than loans. This is particularly important in the context of indirect ownership, as the borrower may have limited information on the ultimate beneficial owner.

While we are entirely sympathetic to the need to protect the Exchequer, we also have some reservations around how the unallowable purpose rule might work in practice. It would be impossible for the borrower to know the intention of its lenders, and particularly to track how their intentions might change after the bond has been issued. Therefore, we would recommend that any unallowable purpose test is based on the issue date of the security and is not based on an intention test. Again if this test failed during the course of the instrument, the remedy of HMRC should be on the lender and not the issuer.

Other comments

Paragraph 3.15 of the consultation suggests adverse consequences where a loan note is repaid early. There are many commercial reasons which will result in a loan note being repaid earlier than the agreed maturity date, and it would not seem appropriate for early repayment in the ordinary course to be penalised. Retrospectively withdrawing the benefit of the exemption would seem a particularly draconian consequence that would likely discourage use of the exemption where any realistic possibility of early repayment exists.