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Date: 2 February 2016

CREFC Europe response – Investment managers: performance-linked rewards (Clause 22 Finance Bill 2016)

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, including institutional and private equity debt funds, 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 provide comments on the draft legislation published on 9 December 2015 relating to the UK tax treatment of carried interest payable to individual fund managers. Our concerns relate specifically to the potential implications of this draft legislation for CRE debt funds.

We set out our general comments on the draft legislation set out in Clause 22 of Finance Bill 2016 (**Clause 22**) below. Some additional (and more detailed) comments on Clause 22 are set out in the schedule.

We are at your disposal should you wish to discuss these comments in more detail.

Background

The functioning of business in the wider economy relies on investment by a professional CRE industry. It provides accommodation for businesses and other occupiers that is fit for purpose, offering them the flexibility to suit their premises to their changing needs and changing economic conditions. By providing much of our built environment, the CRE industry represents a critical component of the real economy, delivering important socio-economic benefits to communities as well as opportunities for productivity gains for business.

From an investor's point of view, CRE offers a range of opportunities whether in terms of equity or debt. As a capital intensive and long-term business often involving very large, valuable and illiquid assets, CRE is dependent on the ready availability of credit. This dependency is driven principally by the very different risk and return expectations (and hence cost) of different types of capital.

Investors have long recognised the appeal of both equity and debt exposure to CRE. Owing to the specialised nature of CRE, most forms of investment command an illiquidity premium which longer term investors find especially attractive. The equity investor base is diverse and includes non-listed institutional and private equity funds.

By contrast, until the financial crisis, the European CRE debt market was overwhelmingly dominated by banks. This led to concentration risk and a lack of transparency or liquidity that continues to afflict Europe's financial system and economy. However, since the crisis, various kinds of CRE debt

funds have emerged. Most originate or participate in new CRE loans, helping diversify CRE risk away from the banking system and providing a mechanism for non-originating capital to gain CRE debt exposure. Some specialise in junior or mezzanine debt, filling a gap in the higher-risk part of the market no longer attractive to banks that are (quite rightly) adopting a more conservative approach than they did before the crisis. Others tend to focus their lending activities on senior loans only.

The result of these changes is that the CRE industry is now able to access finance not only from the banks, but also from a range of new lenders and new vehicles for non-originating capital providers (including institutional and private equity debt funds). Further, the existence of such debt funds complements bank credit for business and also helps to promote system resilience through diversification of lending sources. CRE debt funds are a vital vehicle for the gradual diversification of European CRE debt markets.

It is too early to tell whether this new class of non-bank lenders are a long-term feature of the CRE financing landscape, but it seems reasonably clear that the diversification they bring is a good thing for CRE investors, non-originating debt investors and financial stability as a whole. It is important that policy interventions do not undermine it.

In commenting on the provisions in Clause 22, we are doing so from the specific perspective of CRE debt funds that provide credit to the CRE sector, whether at senior, mezzanine or junior level. Such loans tend to have maturities of between three and seven years: maturity and other terms being influenced primarily by the general CRE market, and in particular the financing needs of borrowers.

General comments

1. Differentiating direct lending funds from other funds

We would ask the government to reconsider its proposal to treat debt funds that constitute direct lending funds differently from other investment schemes. In the light of the comments made above, we would argue that the current approach risks undermining broader policy goals (promoting diversity of supply of credit to the CRE industry in the interests of borrowers, debt providers and financial stability). It is also difficult to justify in terms of the narrower policy considerations behind this draft legislation.

The approach taken in s809FXM, taking account of the government's stated objectives in relation to this legislation, effectively contemplates that a fund that originates loans is to be seen, prima facie, as carrying on a trading activity (hence the application of a default rule that carried interest should be taxed as income). We see no basis for such an approach: not only does this run counter to what we understand to be HMRC established practice, but, as a potential precedent (in terms of indicating a particular HMRC viewpoint on such activities) it is particularly unhelpful. It marks a fundamental shift in approach, and it is therefore disappointing that this change has not fully benefited from the consultation process that has applied to Clause 22 more generally.

In particular, we do not consider that lending activity should be penalised in this way. The UK tax rules have historically accepted that originating loans with a view to holding those loans to maturity should be accepted as an investment activity – see, for example, HMRC practice on securitisation companies. The activity of a fund that originates loans to hold to maturity generally differs from that

of a bank (for example, a bank engages in maturity transformation through its lending activities) and so such a fund is not readily comparable to a financial trader.

If HMRC's concern is the term of the relevant loans (which appears to be the case given the definition of direct loan, particularly s809FZM(3)((b)(d) and (e) and s809FZN and the limited explanation of this provision in the Summary of Responses published at the same time as the draft legislation on 9 December 2015), it is difficult to see why the average holding period approach could not similarly apply to such funds - particularly given that the effect of the "safe harbour" provided in s809FZN is to apply the average holding period rule to such debt funds in any event.

We are concerned that the provisions relating to direct lending funds create a cliff effect, even when taking into account the provisions of s809FZN. This approach – which links income/capital treatment to a fixed period of ownership – mirrors Option 1 as set out in the original consultation. We note that Option 1 was firmly rejected in favour of Option 2 (for the reasons set out in the Summary of Responses). The arguments that led the government to favour Option 2 apply equally to direct lending funds.

Further, it is unclear from the comments made about the direct lending fund rules in paragraph 4.2.10 of the Summary of Responses why a lending fund should be differentiated in this way: there is a lack of information as to why the government considers a different approach justified. There is a reference to a concern about "other lenders trying to move to a carried interest structure" – but there is no explanation as to what the perceived risk is here. If that 'other lender' is a collective investment scheme or investment trust, it will be within Clause 22 in any event. If there is a particular avoidance concern, then it would be helpful to understand why such concern could not be addressed specifically in the legislation, rather than introducing a general principle applicable to all lending funds (not just those funds where the government is concerned about potential tax risk).

In the absence of a more detailed explanation as to the rationale for s809FZM, we have therefore looked to the government's original consultation on the purpose behind the new measures. The stated purpose behind this new legislation was to restrict capital gains treatment of carried interest payments to cases where the fund's activities were of an investing nature. Given that loan origination, where loans are to be held to maturity, is not itself determinative of trading status – a view that HMRC has endorsed in the past in other contexts – it seems to us hard to justify a special deemed "trading" activity under these rules just because a fund originates debt – particularly given that a direct loan is defined as a loan which the fund has the "positive intention and ability to hold until maturity". A fund that makes direct loans is clearly not seeking to "churn": it simply acquires and holds. We struggle to understand why the fact that what is "acquired and held" on day one is a loan (and not shares or marketable securities) should lead to such differentiation in treatment. We note that the government has included a safe harbour for funds where loans are made for four years or more: but although this may mitigate the impact in some way, it does not address the fundamental concern we have as to why "lend to hold" is treated in such a way.

Further, the proposed mitigant (s809FZN) seems to us to re-introduce into the legislation all the difficulties identified as arising under Option 1 (of the original consultation), which led to Option 1 being rejected. The consultation suggested two ways of addressing the government's concerns. Option 1 suggested using a fixed minimum ownership period, which varied by reference to the

nature of the underlying investment, to determine the characterisation of carry. The second, Option 2, suggested an approach based on an average holding period of all assets.

In the Summary of Responses, the government said that Option 2 was a sensible option to cater for funds with different activities. The definition of direct lending fund – namely, a fund expected to have a simple majority only of investments that are direct loans – runs counter to this. A fund that intends that just over 50 per cent of its investments will be direct loans will have other investments, and thus be carrying on different activities. Under the proposals, unless the "safe harbour" applies, carried interest calculated by reference to those other activities, whatever they may be, will be taxable as income. If the safe harbour does not apply, a fund may find that the majority of its investments are held for over four years (the period that the government suggests represents long-term investment) and yet the manager is still taxed on carried interest from such investments as income: this does not seem equitable or (for the reasons given above) justifiable on policy grounds.

Therefore we would ask the government to reconsider the inclusion of a special provisions for direct lending funds: instead we would ask that such funds are treated no differently to other forms of investment vehicle.

Alternatively, we would ask that the commencement date for direct lending funds be deferred to allow for a proper informed consultation on the issues involved to ensure that any provisions that treat direct lending funds differently to other funds are appropriately targeted to address the concerns of government. Pending the outcome of that consultation, such funds would be subject to the average holding period test, as other funds are – so should their activities be short-term in nature, a proportion of any carry would be taxable as income in any event.

If after such consultation, the government considers no changes are needed, the provisions could be brought into effect by statutory instrument at the relevant future date; similarly regulations could amend the definitions to reflect the outcome of such consultation. Clause 22 already contains wide regulation-making powers in s809FZP: a specific regulation making power concerning the making of provision for the definition of a direct lending fund and any exceptions to that definition could be added to s809FZP(2) if there were any uncertainty as to its scope in this context.

2. Definition of direct lending fund

If the government remains minded to retain specific measures aimed at direct lending funds, we would ask that the definition of direct lending fund be reconsidered.

The current definition means that a fund will be a direct lending fund where it is reasonable to suppose that a majority of its investments will be direct loans (as defined). "Majority" here suggests a simple majority: i.e. over 50 per cent.

For many lending funds, loan origination will form the core of its investment strategy, with other investments representing no more than a small proportion of its investment portfolio. However, there may be other funds where loan origination is expected to play a significant part in its investment strategy, but that investment in other assets (whether securities, loan participations acquired on the secondary market or other CRE related investments) are also an important part of the overall strategy.

Taking account of what the government has said in the Summary of Responses about the value of Option 2 in relation to funds with different activities, we consider that a threshold of direct loans of 50.1 per cent is too low to trigger default income tax treatment. We consider that the definition should instead require there to be a higher proportion of direct loans within a fund's intended portfolio if that fund it to be a direct lending fund. As a result, automatic income characterisation of carried interest is only in point should the making of direct loans be the sole or main activity of the fund (which would suggest a threshold of at least 70 per cent, and possibly higher).

Additional comments on the definitions of direct lending fund and direct loan are included in the Schedule.

3. The direct lending fund safe harbour

As currently drafted, the safe harbour in s809FZN(1) only applies to those debt funds that are constituted as limited partnerships. We recommend that the safe harbour be extended to apply to any investment scheme, regardless of form. Debt funds can be set up in corporate form, and we see no policy justification for excluding an investment scheme from this safe harbour just because it is not a partnership. The purpose of these provisions is to characterise carried interest by reference to the activities of the fund (as is clear from the original consultation). By excluding funds other than limited partnerships from 809FZN, the characterisation of carried interest for a fund that is a direct lending fund is primarily determined by its form, not its activities.

Further, the terms on which CRE loans are advanced reflect general market conditions and what borrowers are looking for in terms of commitment. CRE loans in general can be for period from three to seven years, depending on conditions at the time and borrower demand.

The original consultation, when discussing Option 1, suggested a three year period for secondary market debt (as well as debt to venture capital companies). We would ask that the four-year requirement in the safe harbour be replaced with a three-year condition. We consider that, given that a direct loan has to be negotiated on an arms length basis with an unconnected borrower, and given that falling within the safe harbour simply results in the fund being subject to the standard rules, this would not defeat the government's objective of taxing carried interest payable in respect of short-term activities as income. If a fund is primarily making three-year loans, then a significant proportion of any carried interest may be taxable as income in any event under the average holding period rule, but equally it will not be precluded from CGT treatment to the extent that the loan portfolio also consists of four to five year loans (i.e. longer term activities).

4. Transitional provisions for direct lending funds

As stated above, the singling out of direct lending funds as prima facie being on the "wrong" side of the income/capital line represents a significant change to the current understood position. This proposal was only publicly announced on 9 December 2015 and is due to come into effect, for all funds whenever set up, on 6 April 2016.

The test as to whether a fund is a direct lending fund or not (or whether it is within the safe harbour) is a forward looking test: it is an objective assessment of what investments the fund anticipates making that is required to be made at the time the fund is set up (by reference to any prospectus or

similar). For an existing fund, this seems to suggest that the managers need to look back as to what might have been reasonably supposed at the time the fund was launched (which for some could be 6 years ago).

The position here differs from the general application of the rules to other funds: the average holding period looks at the facts as at the date carry arises post 6 April.

For existing debt funds, their characterisation under the rules is thus a retrospective one, and also, in some ways, seems particularly artificial: after all they are being asked to make a forward looking assessment retrospectively – almost an oxymoron. The reality of what the fund has done – i.e. whether its activities have been long-term (in the government's view) or not is irrelevant, unless the safe harbour applies.

We would therefore ask that the government considers limiting the definition of direct lending funds to funds established on or after 6 April 2016, for which a forward looking assessment is appropriate.

Funds set up before that date would not be excluded from Clause 22: instead they would fall within the same rules that apply to other funds (so future carry is characterised by reference to what has happened in terms of the portfolio, rather than what might have been supposed x years previously).

In particular, such a safe harbour for existing funds avoids any risk of retrospection in the characterisation of carried interest: for some debt funds, carried interest is determined on a whole fund basis, towards the end of the life of the fund. For such funds, automatic treatment of carried interest paid on or after 6 April as income represents retrospective taxation given the change in expectations as to the tax consequences from those which applied throughout the investment period. By allowing existing debt funds to apply the average holding period rule, the treatment of carry is then based on the activities of the fund throughout its life to date.

5. Conditional Exemption

The Summary of Responses indicates that the intention underlying s809FZK and s809FZL is to make provision where carried interest is paid early (as a result of which, at that time, the average holding period will always be less than four years by reason of the timing of the carry) but the average holding period is expected to exceed that four year rule in practice.

Our concern with s809FZK is that the approach taken in the legislation does not achieve this objective. This is because the conditional exemption rules only apply to carried interest that arises in the first four years of the fund's life (as per Condition A). Given that the majority of funds will have an initial investment period of between one and three years, and that the legislation works by way of weighted average, it will easily take up to six years before a weighted average can be guaranteed to be at least 48 months. Therefore, managers of funds that have long-term investment activities could still be penalised under these rules (i.e. with carried interest taxed as income) where carry is paid out in say, year five simply by reason of the law of averages.

For example, assume Fund X has a three year initial investment period. It has an eight year life. It receives £500m from investors on 1 January 2016.

On 1 February 2016, it invests £50m in asset A.

On 1 May 2016, it invests £60m in asset B

On 1 June 2016, it invests £75m in asset C.

On 1 November 2016, it invests £30m in asset D.

On 1 March 2017, it invests £100m in asset E.

On 1 June 2017, it invests £90m in asset F.

On 1 November 2017, it invests £95m in asset G.

The first four years expires 1 Jan 2020.

Under the fund documents, carry first arises in June 2020 – assuming that asset C was sold.

At that point the only assets to have been held for four years or more are Assets A, B and (subject to the precise timing of the sale), Asset C (the total value of investment being £185m). The majority of the assets (by value invested – at £315m) have been held for less than four years. (Given the nature of this example, we are not "weighting the average" by individual assets for simplicity, but working on relative values either side of the four year cut off as a short-cut to highlight the principle.) This means that part of the carried interest that arises in June 2020 will be taxable as income. As the carry arises more than four years after Asset A was acquired, no claim for conditional exemption is available.

This seems inequitable – particularly if the remaining assets are then held until 2023/24, and sold as the fund approaches the end of its term, and so all other carry is taxable as capital.

The "average" will only ever get to four years if the relevant conditional exemption period respects that fact that funds will generally invest over a two to three year period – and that the most valuable investments may not be the first investments acquired. Using the example above, and assuming Asset C was sold when owned for less than four years, it may take until 2021 for the average to work out at a minimum of four years.

As a result we would ask that the period in which a claim for conditional exemption can be made be extended to the earlier of (a) the life of the fund and (b) (a minimum of) six years, in order that these provisions can operate as the Summary of Responses suggests is intended.

6. Average holding period and debt finance

6.1 **Early repayment:** We welcome the provision at s809FZN(4) which deems a loan to be held for four years when it is repaid prior to maturity by a borrower (although note we have included some detailed comments on it in the Schedule).

The Summary of Responses asked for any other examples where a loan may terminate before maturity for reasons outside the lender's control. Two specific cases are illegality and default: in both cases a loan becomes due and payable immediately. In the case of default, a material default will allow the lender to accelerate the loan (i.e. the loan is due and payable (either automatically under the terms of the loan or at the option of the lender). This will normally be a precursor to the lender taking enforcement action. If the loan has been syndicated, the decision to act in these

circumstances will be made by the lenders acting together (whether by majority or unanimity will depend on the terms of the loan: the influence of the fund will depend on the value of its interest).

If the holding period of a loan originally made for a term of at least four years is reduced because of a default by the borrower, we consider that this should not adversely affect the fund's average holding period of that loan. We would therefore ask that a similar deeming provision address enforcement issues (the decisions the lender makes following such a default, including the possible sale of that non-performing loan at a discount to another investor, result from, and are a reaction to, the default, rather than being a voluntary act as such). Absent such a provision, a default and its consequences could, depending on the relative value of the non-performing loan and other loans, adversely impact the fund's average holding period.

6.2 **Weighted average:** For direct lending funds within the exception, the characterisation of carry is dependent on the weighted average of investment holding periods. This compares value of investment with time held.

In this context, we would question whether the deemed holding period should be the period until final contractual maturity (given that the determination of the character of carry as income or capital is based on a weighted mean, deeming a period of four years for a direct loan of say seven years distorts the weighting: see further the comments in the Schedule on s809FZN(4)). If for example, a significant loan made at the outset of a fund's life prepays, and carry is calculated say in year five, and assuming that other direct loans made by the fund were advanced later on in the initial investment period (and so have then been held for two to three years), there could still be an adverse effect on the carry (notwithstanding s809FZN(4)) due to a borrower choice. (For completeness, we note this could potentially be ameliorated if all direct loans were deemed to have an average life of (a minimum) four years unless there was an actual disposal – see comments in the Schedule.)

In addition, as described in the Schedule, some debt funds may initially commit to advance funds greater than their planned investment, with a view to syndicating part of the advance (there can be various reasons for this). The impact of syndication could distort the calculation of average holding period, even though the syndicated part of the loan is not strictly an "investment" and therefore has very limited effect on the fund's returns. We consider that the impact of syndication should be considered further – with perhaps an adjustment to the meaning of "relevant investments" to provide for a disregard where syndication occurs in defined circumstances.

6.3 **Nature of loan financing/"investment":** The provisions do not define "acquisition", other than in relation to investments that constitute a controlling interest (see s809FZI) which contain specific rules for further investment (allowing an effective aggregation).

Given the nature of debt finance, where a lender commits to lend amounts upfront or in the future, it needs to be clear in the legislation that the loan is treated as a single investment, made at the date the loan is entered into by the lender (either execution of the loan agreement on origination or on assignment/novation where bought as part of primary syndication or in the secondary market).

With loan finance, a lender commits to provide relevant capital at the time the loan agreement is made. The investment in the loan should therefore be treated as being made on the date at which the loan agreement is executed, not the date at which an advance is made.

Similarly, where a loan agreement allows the borrower to draw down further funds at a future date (for example, to fund capital expenditure on the CRE or under a development facility), those further advances should be regarded as being part of the original investment, and not constituting a further investment. This accords with the commercial reality as far as the lender's balance sheet is concerned.

The same position should also apply if, on the scheduled maturity date, the loan is extended as this represents an extension of an existing credit, and not the creation of a new one – extensions to loans have been quite common post financial crisis, and those circumstances could arise again.

7. Derivatives

The legislation excludes derivatives that are designated a hedge of an investment. However a fund may borrow from third parties, and enter into a derivative to hedge the resultant liability. Such derivatives should also be excluded as investments (ie 809FZG(2) and 809FZH(2) should apply as equally to hedges of liabilities as they do to hedges of qualifying investments).

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

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Schedule

We set out below some additional comments on Clause 22, by reference to each proposed section of the Income Tax Act 2007 in turn.

Section 809FZC(2) and 809FZC(5)

We assume that guidance will set out how a fund determines those assets that represent its "relevant investments" taking account of the disregard set out in sub-section (5). It would be helpful to include a definition of "intermediate holding" and of "intermediate holding structure", with guidance explaining how the disregard should work in practice.

Is this intended to apply to wholly-owned intermediate corporate entities only (given that partnerships would be generally transparent)? Is an apportionment required where a joint venture is involved?

These issues will be particularly important when it comes to identifying the disposal of an investment (see comments on s809FZD below). It is therefore important to be clear as to what is intended here. Debt funds may set up corporate SPVs to make loans to third parties, and may fund that SPV with debt (so the SPV acts as a conduit). The relevant investment should be the loan to the third party: we assume this is intended.

We note that the concept of "relevant investments" is defined to mean investments for the purposes of the scheme and "by reference to which the carried interest is calculated". The Explanatory Notes state that, in the case of a whole fund carry, this means all the investments held by the fund. There is no indication as to which investments count as relevant investments where carry is calculated on a deal-by-deal basis. Deal-by-deal calculates the carried interest by reference to the particular investment that is sold, but this does not mean that "relevant investments" are limited to that single investment – particularly in a cumulative deal-by-deal model. Given the importance of the concept of "relevant investments", clarity is required on this point. If two funds are essentially the same in terms of the investments they make and the length of time for which those investments are held, the tax treatment of the carried interest should not be different simply because one pays carry on a deal-by-deal basis whilst the other pays on a whole fund basis.

Section 809FZC(6)

We would be grateful for clarification as to how s809FZN(4) is intended to interact with this provision. Under s809FZN(4), which applies generally for the purposes of Chapter 5F, an early prepayment of a qualifying direct loan is disregarded, with the effect that the loan will be treated as held for four years at the time the calculation is carried out.

We assume that this means that, at the time that the average holding period of investments is calculated (i.e. when carry arises), any loan that prior to that time has been repaid early (in whole or in part):

(a) will fall to be taken into account as part of the calculation within s809FZC(6)(a) (as it is an investment that has been disposed of – s809FZN(4) does not deem there not to have been a disposal); but that

(b) it is assumed to have been held for four years at the time at which it was disposed of (even if, assuming it has not been pre-paid, and was still held at the time the calculation is done, the relevant period would be less than four years).

Is this correct? Can the interaction of these provisions be made more explicit within the legislation (perhaps s809FZN(4) should be included – or at least cross-referenced – within this earlier section to facilitate this)?

Please see the general comments on "Average Holding Period" relating to how the holding period of loans should be determined (in terms of acquisition).

An additional point arises in relation to the operation of the lending market in practice. In certain cases, say where a borrower is looking to obtain senior and mezzanine finance, a debt fund may agree to advance both loans, with the intention of syndicating the whole or a significant part of say the senior, and retaining the mezzanine. The syndication would be a disposal, and the holding period would be short. In such circumstances, the value of the senior could be significantly greater than the mezzanine, and so would have a distorting effect on the calculation of average holding period. The part syndicated was never intended to be held for the purposes of the fund although taking it on may assist the fund in terms of pricing and/or in securing the deal (i.e. the borrower needing certainty of execution may prefer one lender who takes the risk of selling down).

Given that the rules relating to lending funds recognise the role of syndication (i.e. a loan is made by a fund if acquired within 120 days of being initially advanced), would it be possible to apply an equivalent principle in reverse where a fund makes such a loan where syndication is planned (and occurs). This may be something that can be better covered in guidance, than in legislation – i.e. in terms of what is a relevant investment. The reason for raising this is that the loan will be an investment made for the purposes of the scheme – and, although it is extremely unlikely to have any relevance to carry given the limited income that will arise during the short holding period, particularly given the application of hurdle rates, the nature of the fund documents may mean that it is not expressly excluded from being taken into account as an investment in any calculations of carry as a contractual matter (as opposed to the practical reality).

Section 809FZD

The meaning of disposal borrows from the Taxation of Chargeable Gains Act 1992.

There are a number of provisions within the TCGA that deem a disposal to occur. Given the broad definition of deemed disposal in s809FZD(2), we would suggest that the reference in 809FZD(1) to disposals for the purposes of the TCGA is limited to actual disposals only (as per section 21 TCGA). This would, by way of example, exclude the provisions dealing with capital sums and compensation monies, value shifting and degrouping. If there were any specific deemed disposals that the government felt should be included as a disposal within s809FZD(1) that is not caught by subsection (2) – for example, s122 TCGA relating to capital distributions – this could be specifically included.

Please can you clarify as to how this provision applies where a fund holds its investments via SPVs. If say a fund sets up SPV Holdco, that owns SPV and SPV makes the relevant investments (i.e. the underlying loans or securities that the fund investment strategy links to), an exit from that

investment could be effected by any of (a) sale of SPV Holdco, (b) sale of SPV and (c) a sale of the underlying investment.

The definition of disposal in (1) seems to be limited to option (c): it is this that is the disposal of the investment for the purposes of the scheme (construing "investment" here as in effect a "relevant investment", given that a disposal is material to determining the length of ownership of an asset). If this is the case, then the disregard in s809FZD(5) would apply to allow that investment to be identified. This also seems supported by the reference "to investments for the purposes of the scheme".

If this is the case, then a disposal in (a) or (b) would be within (2) as a deemed disposal (in either case there is no TCGA disposal of the underlying investment as its owner remains the same). Is that correct? Can this be clarified in the legislation (or in guidance) so it is clear that (2) applies where a relevant investment is disposed of indirectly because of an actual disposal of an intermediate holding.

Please confirm that a disposal for TCGA purposes of investments of the scheme does not include part disposals occasioned as a result of a change in partnership sharing ratios (which trigger a disposal under s59 TCGA and SP D12)? If necessary, this should be specifically excluded from the definition of disposal.

If a fund makes an investment directly, and subsequently transfers it to a SPV (or indeed a company buys an investment by buying a holding company, and then transfers the underlying asset to a new SPV), there will be a disposal of the investment: but this should not be caught by these rules. This may be intended to be caught by subsection (1)(a) by the reference to there being a disposal of the investment "for the purposes of the scheme" but the language here is not as clear as it could be. This may again be a point for guidance.

We would also ask whether this provision should cross-refer to s809FZN(4) to make it clear that a borrower repayment in that context is not a disposal.

Finally, although subsection (1) suggests that the definition of disposals is finite (i.e. limited to circumstances (a) and (b)), other provisions within the Chapter also can apply to deem a disposal (e.g. the rules relating to derivatives): should these be signposted here?

Section 809FXH(6)

Can it be confirmed that the definition of securities here encompasses loans (and not just debt securities)? There can be ambiguity as to the scope of this term, and hence the request for clarification.

Section 809FZI

Please see general comments on "Average Holding Period and debt finance".

We consider that where a lender makes further advances under a loan, including an advance that results from interest being paid by way of an issue of funding bonds in accordance with the loan, the "investment" represented by such further advance should be treated as made as and when the initial loan was made: i.e. it is treated as part of a single loan.

Section 809FZK

Please see general comments on "Conditional Exemption".

Section 809FZM

Please see general comments on direct lending funds.

Section 809FZM(1): The test to be applied to determine if a fund is a direct lending fund is a forward-looking test. We assume guidance will provide sufficient information as to how a fund should assess this? In particular, the use of the term "it is reasonable to suppose", and how that is defined (i.e. by reference to the prospectus) suggests that this is to be supposed (reasonably) at the time that the fund is launched: i.e. at the time the fund is launched, an assessment has to be made as to what the portfolio will have consisted of at the time the fund is fully invested. If so can this be specified in 809FZQ – i.e. the reference to all circumstances for s809FZM and s809FZN is to the circumstances at the time the fund is launched. This is important to provide certainty that the test is forward looking at outset, and not something that is re-tested at any time. Further it needs to be clear as to what HMRC consider supports such a reasonable supposing – i.e. what objective evidence would HMRC expect to exist for a reasonable supposition to be accepted as such?

It is important that this is clear, and so a fund knows the factors that are relevant: this is because the requirement is an objective test and thus taxpayers need to understand how HMRC see this operating in practice.

In addition, the disregard in s809FZC(5) would not appear to apply for the purposes of this provision (it is limited to the matters set out in subsection (5)(a) and (b) – as confirmed in the Explanatory Notes). Many debt funds set up SPVs to advance loans to borrowers: we assume it is these loans that are looked at in terms of direct loans (not any funding of the SPV) (we note that "investments made for the purposes of the scheme" suggests this is the case, but would also note that similar language is used in s809FZ where a disregard was seen as needed). Does a disregard provision need to be added?

Section 809FZM(2): As a drafting matter the reference to value invested in the penultimate line should be to value advanced (mirroring the language of s809FZN).

Section 809FZM(3): We have a number of concerns about the definition of direct loan.

First, it is unclear what is meant by a "genuine commercial loan agreement" – is not an arms length test sufficient (though, if the company is unconnected, we are unclear what an arms length requirement adds)? This will need to be covered off in guidance.

In relation to (e), what has to be shown to demonstrate a positive intention (we are unsure why there is a reference to the intention being "positive": we are not sure what this adds to having an intention: it is concerning here, as it suggests something additional.

In this context, there may need to be clarification as to how this test applies to a loan advanced by a fund, where (from the outset) the fund has the intention to syndicate part (retaining the remainder to hold to maturity).

Finally, the definition refers to loans made to a company. Note however that a borrower may not necessarily be a company – the legal form of the borrower is determined by the borrower group (not the lender). In a CRE context, borrowers can include partnerships (both general and limited), and also unit trusts (which, for some tax purposes, can be deemed to be corporate). This is important given the use made of the concept of direct loan in the safe harbour in s809FZN(1) and also in s809FZN(4).

Section 809FZM(4): We note that this deems a loan to have been made by a fund if it acquires that loan as part of a primary syndication, for example. Should this be limited to where the acquisition is from the original lender to ensure it catches only those acquisitions that arise on syndication? Given that this links to the application of a forward looking test as to what a fund intends to invest in, it seems unlikely that this could provide a means of avoidance.

Section 809FZN

Please see general comments on direct lending funds and early repayment.

See comments on s809FZM concerning "reasonable to suppose".

Section 809FZN(1)(c): To be within the safe harbour, the carried interest must fall within s809EZD(2) or (3). The effect of this is that a direct lending fund will not qualify for the exception unless the hurdle is at least 6 per cent. In a debt fund context, 6 per cent may be too high a hurdle rate in terms of investor preferred return: but regardless of this, in any event, we would ask that the exception also apply if the carried interest falls within the alternative definition of carried interest in s809EZC as a matter of definition (s809EZD deem a sum to be within that provision).

Section 809FZN(4): Please confirm that this includes scheduled repayments (for example, as part of amortisation), mandatory prepayments (for example, due to illegality on the occurrence of an insurance event, a borrower may be required to use the proceeds to prepay the loan) as well as voluntary prepayments.

Guidance should also confirm that this can apply on multiple occasions: ie if a borrower prepays the loan in part in year two, and then makes a further prepayment in year three, the loan continues to have a deemed life of the specified period.

The effect of this provision is to deem a four year life for the purposes of the average holding period rules, where the conditions are met. We assume that this applies to a direct loan made by any fund, not just by a direct lending fund, given the provision operates generally for the purposes of the Chapter. We consider that this is appropriate given the nature of a loan – and in particular that a lender has no influence on the timing of the exercise of a prepayment right or option by a borrower – or indeed on the timing of a circumstance which may trigger a mandatory (p)repayment. We would ask that a clear link/signpost between this provision and s809FZC is included in the legislation – so that the scope is clear.

Given that a direct loan is made to an unconnected company at the outset, and that the borrower needs to be unconnected at the time of the repayment (we assume this is the time at which (c) is tested), and the other requirements we do not understand the need for (d) – and in addition how this condition could apply in practice. If it is to be included, we would ask that the guidance explains

what this is directed at – it is unclear to us how a borrower prepayment would impact s809FZM's application? In particular, where a loan provides in its terms for a prepayment (either amortisation, on an illegality or because of an insurance event), we consider that (d) should either not apply, or should be deemed to be met (given that the prepayment is contractual). Given the definition of direct loan (and in particular limbs (a), (b) and (c)) we would hope that this would not be problematic.

This provision applies if a loan has been prepaid (in whole or part). As a result, under the rules a direct loan (with a term of at least four years) will generally be deemed to have a minimum four year life – whether because it is repaid on maturity or prepaid by the borrower (both cases being based on the contractual provisions within the loan) – unless there is an actual assignment or novation (or other disposal) of the loan by the lender.

If the provisions relating to direct lending funds remain broadly as drafted, we would ask you to consider including within the legislation a default rule to the effect that, where a fund falls within s809FZN(1), a direct loan of a minimum four year term will be deemed to be held for at least four years unless there is a disposal of it by the investment scheme for the purposes of the Chapter.

This would simplify the calculation when carry arises and effectively provides a conditional exemption for those direct lending funds that have a strategy of long-term committed finance (and hence fall within the safe harbour). If the reality of the investment strategy changes, the normal rules will apply to take that disposal into account. This is in accordance with the policy objective of providing capital gains treatment to those funds that provide long-term committed finance. Given that the definition of direct loan includes an intention and ability to hold to maturity, and the additional requirements of the safe harbour, this would not seem to us to result in any additional opportunities for avoiding an income tax charge that would otherwise arise. It seems a logical follow-on from the effect of s809FZN(4).

Similarly, s809FZN(4) is drafted to apply to direct loans – namely, loans advanced by the relevant fund. However similar issues apply to loans acquired by a fund subsequent to primary syndication: i.e. if the loan, when advanced, has a term of say six years and the fund purchases it in year two, then (assuming the fund has the intention to hold until maturity) the fund will generally be anticipating to hold for four years. A borrower prepayment would reduce that holding period as a result of an event outside the lender's control. Therefore, should the principle underlying s809FZN apply more generally to loans with a term of over four years (not just those "made" by the fund) – noting, in this case, that the deemed holding period would need to be adjusted to reflect when the fund acquired the loan.

Finally, we would ask you to consider deeming the holding period of the loan under s809FZN(4) to be the period to the maturity date – i.e. the date on which the loan is to be repaid at the end of its term. If the borrower had not prepaid, the intention of the fund would have been to hold to maturity (as per the definition of direct loan – limb (e)). Given that the average holding period calculation is a weighted average, the length of time for which an investment is held is a material factor – and so, on the basis that a repayment by a borrower does not itself deem a disposal to have occurred, deeming a holding period that reflects accurately what was anticipated/intended absent that repayment seems more equitable. If there are concerns as to relying on contractual maturity, as

an alternative, it would be possible to "borrow" from s809FZN, and deem the holding period to be the period up to the end of the "relevant term".

Section 809FZO

We would ask that guidance provide examples of the circumstances in which HMRC would expect these anti-avoidance provisions to be triggered.

Section 809FZQ

Please see comments on s809FZM above.