**Response to HMT consultation on the tax treatment of asset holding companies (AHCs) in alternative fund structures**

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 (including credit funds), intermediaries and advisory businesses, and real estate firms that use debt to finance their activities.

Our submission in response to the consultation *The tax treatment of asset holding companies (AHCs) in alternative fund structures* published by HM Treasury in December 2020 (the **Consultation**) focuses on fund structures used to provide credit to commercial real estate firms – referred to below interchangeably as CRE debt funds, CRE credit funds (or just debt funds or credit funds).

**Key points**

We welcome the Consultation and the proposal for a new regime, particularly if it is seen in the broader context of the government's review of the UK's funds regime, and if the focus on tax does not crowd out other considerations (whether regulatory or commercial). We believe that there is scope for enhancing the attractiveness of the UK and UK vehicles.

The most important points we would make are as follows.

(a) **Avoid complexity:** the regime needs to be as straightforward and simple to administer as Exchequer considerations allow. Otherwise, there is a strong likelihood of limited take up, as fund managers will stick with tried and tested vehicles and structures.

(b) **No 'one size fits all':** funds for different purposes (venture capital, private equity, real estate or credit) work differently and this needs to be reflected in the regime. We would recommend focusing on what is common across those different sectors in terms of eligibility, and then applying more complex rules on a targeted basis, as may be considered appropriate for particular categories of fund.

(c) **Tax neutrality:** a common feature across funds that raise institutional capital is that investors should not be disadvantaged for investing collectively compared to the position they would be in had they invested directly. For new UK rules to have a chance of attracting fund structuring business that has traditionally gone elsewhere, they must respect that principle.

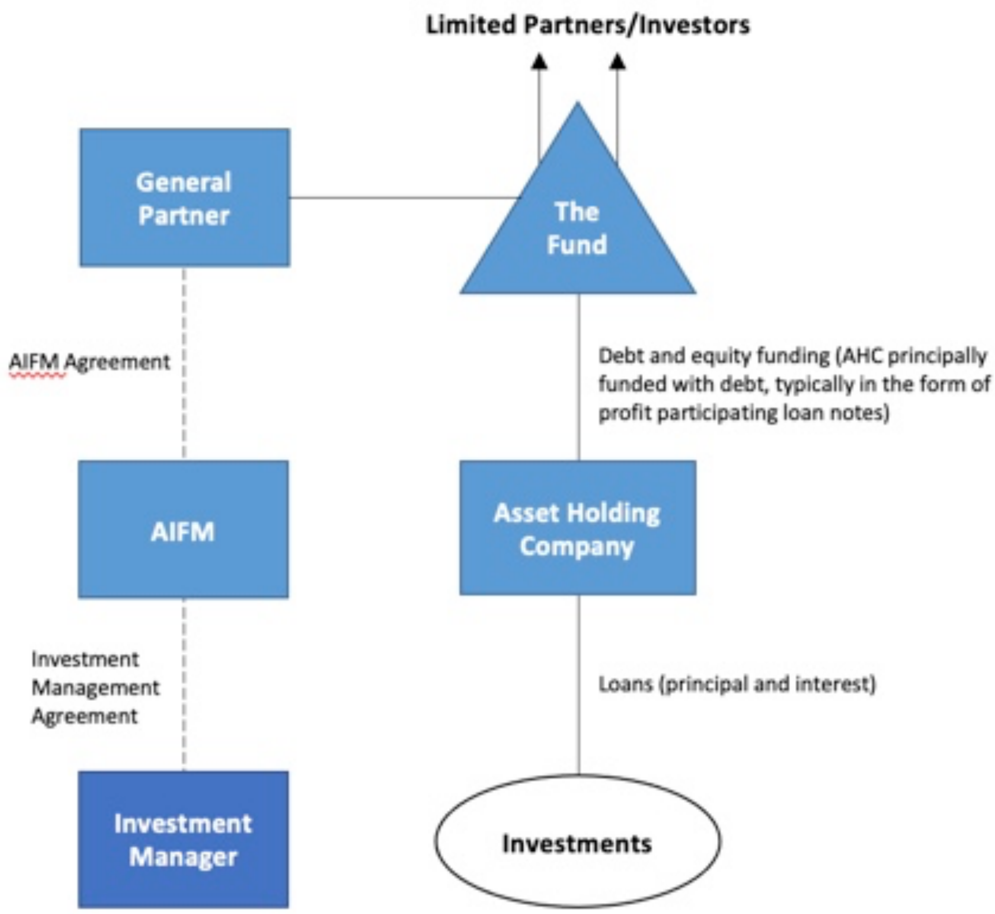
(d) **Competitiveness:** the way in which an AHC operates and the tax regime that it is subject to must be competitive with existing structures commonly used in jurisdictions such as Luxembourg and Ireland if it is to be successful.

We set out below our more detailed comments on the Consultation. We have included in our comments an overview of common CRE debt structures, and the manner in which such structures would be likely to be taxed in Luxembourg. We then comment on those aspects of the Consultation most relevant to CRE debt funds.

**Detailed response to the Consultation**

**A ‘classic’ CRE debt fund structure**

This section of our response provides an overview of a common fund structure adopted by CRE debt funds, as illustrated in the diagram below.




***Fund entity and marketing:*** The fund itself (the **Fund**) is commonly set up as a form of limited partnership. It is likely to be closed-ended, with a limited life of perhaps around seven years (with investments generally made in the first two or three years, although in some cases an early loan prepayment could lead to re-investment). The term reflects the medium-term nature of CRE debt (loans are generally made over a three to five year term, although some funds may specialise in bridging finance or construction loans, which are likely to have a shorter term). However, in some cases, open-ended (or evergreen) fund structures can also be used for CRE debt funds. Investors in the fund are generally (but not necessarily exclusively) institutional investors.

The Fund could be marketed to investors who are invited to subscribe for interests in it, or it could be set up as a form of club deal: i.e., a ‘private’ fund for a small group of investors looking to benefit from the expertise of the fund manager (as well as the ability to pool funds).

The fund manager’s interest in terms of ‘carry’ would be at the level of the Fund.

***Fund investment objectives and role of AHC:*** The general partner contracts with a fund manager that is independent of the investors (although it is common that the general partner is often owned by the fund manager or persons connected to or affiliated with the fund manager). The Fund's objective is to provide a suitable return on investors' capital by providing CRE debt to third party borrowers: that debt is generally non-recourse (although recourse is more common in the context of construction finance and loans to smaller borrowers) and secured on real estate. Loans may be made to UK and/or non-UK borrowers, and relate to UK and/or non-UK land, depending on the Fund's objectives. In some cases, the CRE debt fund's strategy may mean that it is able to lend to borrowers for which bank finance may not be readily available (whether for commercial or regulatory reasons). In other cases, however, the Fund will compete with banks and other institutions in terms of lending opportunities, or partner alongside them (either 'sharing' in the loan pari passu, or providing junior or mezzanine debt alongside senior debt provided by a lender with a lower risk appetite). In such cases, there can be situations where the loan may be originated by the Fund (with the Fund then assigning part to the 'partner' lender), or by the 'partner' lender (with the Fund then acquiring a portion of an existing loan, rather than directly originating).

The Fund will set up one or more AHC subsidiaries, commonly in corporate form to make loans to borrowers when lending opportunities are identified. These could be a series of single purpose companies, or one company that will carry out the Fund's investment strategy and make multiple loans. This is for the reasons referred to in the Consultation, including limited liability, compartmentalisation (or ring-fencing) of individual investments and market practice. Individual AHCs may be held directly by the Fund, or there may be one or more intermediate holding companies.

Funding the AHC to make the loan will generally involve the Fund providing debt finance to the AHC (using capital from investors). That finance may take the form of a profit participating loan so that the total return on the underlying CRE loan can be passed to the Fund (and on to the investors), an interest-bearing loan at a fixed rate (in accordance with a transfer pricing assessment) or a convertible loan – or a combination of such instruments – together with a small amount of equity.

In some cases, the Fund may also access third party debt at AHC level, depending on the Fund's objectives, and to the extent permitted by its investment policy (such leverage can enhance competitiveness in the lending market and/or returns to investors).

***Co-invest:*** In terms of co-invest arrangements, the fact that the underlying is a loan in which multiple lenders can participate means that co-investment in the AHC is unlikely in practice. Instead, the Fund (through its AHC) and any co-investor would be co-lenders (it being likely that an institutional co-investor would use its own AHC to hold its participation in the loan).

***Nature of returns:*** The returns to the Fund arise from payments of interest and principal on the underlying CRE loans originated by the AHC. As CRE debt is commonly floating rate, repayment would generally be of the amount lent only (save where there is an early prepayment where a premium may be payable): i.e., capital gains are not generally envisaged. Part of the AHC's returns may also come from arrangement and/or commitment fees paid by the borrower (under the terms of the loan). Fees may also be payable if the borrower requests amendments to the loan, particularly if there is a restructuring. The CRE loans could be secured on an income-producing investment (of a tenanted asset) or on development assets (involving the construction of a new property or the refurbishment or repurposing of existing buildings).

As the AHC is itself funded mainly by debt, returns are passed to the Fund (and so, where it is transparent, investors) in a similar way: i.e., as debt service (whether on 'vanilla' debt or on a profit participating loan).

There may be some cases (such as in projects of a more speculative nature) where commercially the lender and borrower agree to the terms of the loan including an 'equity kicker': i.e., part of the return to the lender is in the form of a (small) equity stake or is calculated by reference to the profit made when the (financed) property is sold.

Provided that the borrower meets its debt obligations in full, the AHC should not incur any losses. However, in the event of a default resulting in either the borrower repaying less than par or recoveries being less than the amount of accrued interest and principal due under the loan, a loss would result.

***Borrower defaults and enforcement action:*** As above, the Fund is lending on the expectation that the loan will be repaid in full. However, if a borrower defaults, the Fund (through the AHC) may need to take enforcement action. This may simply involve appointing a receiver who steps in to manage the borrower's property (and, as and when the property is sold, the debt is repaid to the extent of proceeds). However, depending on the nature and extent of the security package, and interaction with other lenders, a Fund may take equity ownership of the borrower with either the AHC, or another AHC created for this purpose, becoming a holding company, and itself managing the process of realisation of the borrower's assets. In this case, depending on relative base costs and values, a capital gain may be realised (in the borrower if the property is sold or in the AHC if the borrower is sold) and (unlike the position with a receiver where the borrower retains an equity of redemption) the gain would be to the benefit of the fund.

***Importance of neutrality principle:*** As referenced in the Consultation Document, for the Fund, the key tax consideration relevant to where it establishes its AHCs is achieving effective tax neutrality (as far as possible) for investors. This means that, assuming the AHC is taxable on income and other profits from its CRE lending, payments to investors representing those profits need to be deductible – with any taxable margin reflecting the limited role of the AHC. (Where a loan is repaid on maturity, there is no capital gain as it is only the original principal that is repaid: the returns these Funds target are income-based only. In this context where a loan provides for an early repayment premium, this would generally be intended to compensate for the loss of the originally anticipated future yield (which in itself is 'income return' focused).)

***Withholding tax:*** Depending on the location of the borrower and underlying real estate, the AHC may need to be able to benefit from double tax treaties so that payments to it are not subject to withholding. Similarly, payments by the AHC to the Fund must not be subject to withholding.

***Other taxes:*** Transaction taxes (including stamp and other transfer taxes) must be minimal (and preferably not applicable). Similarly, given that lending is an exempt activity for VAT purposes, ideally there should be no VAT on management fees, as the Fund will not be in a position to recover that VAT as input tax.

**Non-performing loan funds: NPL funds**

CRE debt can also be an asset class for NPL funds. Here, although the Fund structure may be similar and the need for effective tax neutrality for investors remains, the objectives and investment strategy of the Fund will be very different compared to those of a classic CRE debt fund. In particular, loans may be acquired at a discount but realised at a gain compared to the price paid on acquisition of the loan, with that gain then being the 'return' that is repatriated to the Fund (and its investors).

***Fund investment objectives and role of AHC:*** The general partner contracts with a fund manager independent of the investors (as in the case of a 'classic' CRE debt fund). The Fund's objective is to provide a suitable return on investors' capital by acquiring non-performing CRE debt at a discount to face value, with the fund manager using its expertise to work out/restructure the debt to obtain repayment of an amount above that discounted purchase price (albeit less than the principal amount of the debt). Its timescale for achieving a return on a particular CRE debt is likely to be shorter than the timescale of a classic debt fund. By way of example, a bank made a loan of 100 to Propco in 2017; in 2020, Propco defaulted; the Fund buys the loan in 2021 for 50, representing current market value; and in 2023 the property is sold or there is a refinancing, allowing 65 to be repaid on the loan. Depending on the borrower's credit strength, interest may continue to be paid on the loan even after default; if not, part of the repayment proceeds would be attributable to accrued by unpaid interest.

Unlike the classic CRE debt fund, the Fund does not therefore originate debt: it acquires debt on the secondary market after a borrower default has occurred (or after the original lender has concluded that the loan is problematic in commercial and/or regulatory terms, and opted to exit its position). The existing lenders from which the debt is acquired are able to realise their asset (at a loss) earlier than might otherwise be the case, with the benefit, for regulated lenders, of freeing up capital.

For completeness, it should be noted that there may be funds that acquire non-performing debt with a view to on-selling at a profit – but our comments are directed at those NPL funds that use their CRE expertise to ensure repayment at closer to par than the purchase price implied (a 'pull to par' arrangement).

**AHCs – Luxembourg tax treatment**

Given the universal objective of (effective) tax neutrality and the popularity of Luxembourg as a jurisdiction for funds and AHCs, before commenting on issues around the design of a specific UK AHC regime it is worth noting the tax treatment of AHCs in Luxembourg. Any AHC regime established by the UK will need to be competitive with the position in Luxembourg if the UK is to be successful in attracting AHCs. While we acknowledge that any assessment by a fund of possible jurisdictions for AHCs will take account of a number of tax and non-tax factors, the objective of achieving (effective) tax neutrality means that tax costs can be a particularly material factor.

This is a summary of the key relevant Luxembourg tax considerations relating to AHCs for reference in the context of responding to this Consultation (we assume that the Government is familiar with the position following the first consultation).

1. The Fund is usually a partnership structure, whether a SCS or SCSp (a special limited partnership). Sometimes it may be set up as a SCA (which is regarded as a corporate for Luxembourg tax purposes).

2. AHCs set up by the Fund are corporates (SARLs), and can take the form of a 'normal' Luxembourg company (a Soparfi) or that of a Luxembourg securitisation vehicle (SV), depending on a number of factors, including the applicable regulatory regime and tax.

3. Although both types of entity are subject to Luxembourg corporate tax, an SV has a number of tax-related benefits: simplified transfer pricing (in most cases that means effectively no need to transfer price), deduction for finance costs even where the finance is profit participating / results dependent (although this is now subject to the provisions of ATAD 1 and 2), no withholding tax on any interest or dividend payments paid by the SV and exemption from VAT on management fees: as a result a SV can achieve (effective) tax neutrality.

4. There are no eligibility criteria as such for Soparfis, but SVs need to be 'investment' entities (i.e., passive) – so a fund with particularly 'active' strategies cannot use SVs. As a general rule, however, a CRE debt fund should be able to use SVs as AHCs given the nature of its activities (and we understand that many Luxembourg-based debt funds are now looking to use SVs in their structures).

5. If a Soparfi is used, transfer pricing rules apply to determine an appropriate taxable profit which could be between 5 and 50 bps (i.e., 0.05% to 0.5%), depending on the nature and amount of debt. As above, the different rules for an SV means it does not have to have a margin.

6. Luxembourg has a participation exemption so dividends and gains from qualifying holdings are exempt from tax.

7. Normal corporate tax rules apply in relation to deductibility of finance costs. Interest paid on profit participating loans is generally deductible for these purposes. This is subject to the following:

   (a) for a Soparfi, no deduction is allowed for payments funded from either a capital gain or a dividend exempt from tax under Luxembourg's participation exemption. An SV can deduct all distributions made to the Fund;

(b) Luxembourg now applies a corporate interest restriction (at 30%) but this applies to net interest expense only; and

(c) depending on the investors, the anti-hybrid rules may also apply to limit deductions, but here Luxembourg excludes investors with less than 10% of a fund from being subject to the "acting together" rules (we note that that the UK has recently announced that it intends to introduce a similar exclusion).

8. In terms of returning gains to the Fund, options available are (a) as share repurchases/redemptions; (b) income under the profit participating loan or (c) redemption (at a premium) of a convertible security (a CPEC (a convertible preferred equity certificate) or a convertible loan). If using (c), payments should be tax deductible.

9. Luxembourg has an extensive double tax treaty network (both SARLs and SV are residents of Luxembourg for this purpose). There is no Luxembourg withholding tax on interest payments (subject to a cap, which is determined by reference to the transfer pricing analysis – interest payments above this cap and dividend payments are subject to withholding tax). Payments on profit participating loans are "interest". Payments on a CPEC are also not subject to withholding tax.

10. There is no stamp duty equivalent in Luxembourg. AIFs and regulated funds, as well as SVs, benefit from a Luxembourg VAT exemption on management fees. Luxembourg does have a net wealth tax, but it is usually limited to €4,815.

**<u>Responses to Consultation Questions</u>**

Our comments below are generally made from the perspective of the 'classic' CRE credit fund outlined above. Where a particular issue arises in relation to NPL funds, we make that clear – it is certainly the case that NPL funds give rise to greater complexity than 'normal' CRE debt funds.

***Eligibility (Qs 1-14)***

*Ownership*

(1) We agree that the AHC regime should (at a minimum) be available to AHCs that are part of a fund complex in which a wide range of investors and/or institutional investors pool resources which are in turn managed by an independent, regulated or authorised asset manager. (We discuss at (11) to (14) below other types of AHC that should be considered for inclusion within the regime.)

(2) In such a situation, we consider eligibility criteria based on (a) ownership of the AHC by a "fund" entity, (b) the investors in that fund, and (c) the status of the manager to that fund are appropriate (subject to the detail of the specific requirements.

(3) In relation to the definition of a "fund" entity, we agree that the new regime should apply to AHCs that are owned by "collective investment schemes" or Alternative Investment Funds (AIFs): both of these represent a form of collective investment involving the pooling of resources and third party management.

(4) In terms of ownership, we note that the government proposes that the Fund must be widely owned. The approach of using a genuine diversity of ownership (GDO) test coupled with a "non-close" test (based on the close company rules), which the Consultation suggests, was the one adopted for the purposes of Schedule 5AAA Taxation of Chargeable Gains Act 1992 in the context of investment in UK real estate. This therefore has the benefit of some familiarity within parts of the fund sector, and builds on existing UK tax concepts.

(5) However, we would note the following in relation to the use of such tests:

(a) if existing AHCs are to be able to access the regime (which we consider should be the case), the funds that own them may not have structured their marketing in a way that then ticked the GDO boxes;

(b) closed-ended funds tend to retain their initial investors throughout their life (and effectively close to new investors once the initial investment period has ended) – the GDO condition should accommodate this; and

(c) any application of the close company rules in determining "non-closeness" needs to reflect the fact that third party investors' interests are indirect.: we would anticipate that this is the norm (rather than, as section 4.35 of the Consultation implies, the exception). In addition to the fact that investors invest in the Fund, and not the AHC, the Fund may have set up intermediate holding companies between it and any lending AHC.

(6) These types of issue were considered and taken into account within the legislation (in some cases, through amendment to the original legislation: see para 46A, Schedule 5AAA by way of example) and guidance relating to non-resident CGT in Schedule 5AAA TCGA and it is important that they are similarly taken into account when setting eligibility criteria for AHCs. Any amendments to the GDO test should be provided for within the legislation (not guidance) in order to provide certainty for those looking to access the regime.

(7) In addition, we note that the close company rules are particularly wide-ranging, and complex, and so to the extent that the concept of "non closeness" could be provided for in a simpler, more straightforward way, this would be welcome. In particular, the particular nature of a Fund may suggest other adaptations are needed to provide clarity (for example, see the adaptations made in para 46, Schedule 5AAA). The issue here is the need for both simplicity and certainty: it will be key to the success of any new regime in attracting AHCs to the UK that eligibility criteria are clear and straightforward to apply, giving rise to as little uncertainty as possible – particularly noting the lack of such criteria in jurisdictions like Luxembourg. Adapting an existing set of provisions, originally designed for other purposes, so that they work sensibly for a new regime, risks complexity.

(8) In this context we note that, in determining if a person is liable to CGT on indirect disposals, a substantial interest is determined by reference to "equity", defined by reference to group relief rules. In its Final Response Guidance, the government indicates that it is considering a minimum ownership test based on consortium relief rules: in principle, such an approach seems better targeted at true equity-linked interests than 'participators' as per the close company loans.

(9) We welcome the confirmation in the Consultation that "Advancing a loan at a fixed rate of interest to an AHC on arm's length terms will not mean that a person is investing via the AHC, since they will simply receive a fixed, commercial return on the money they have advanced": any 'participation' test should be based on equity-linked participation only. If the close company rules are to apply, however, we ask that the exclusion in s435(4) CTA 2010 from the "loan creditor" definition of banks making loans in the ordinary course of their business be extended to all providers of third party loan finance to the Fund to reflect changes to the lending market landscape over recent years.

(10) In practice, there are likely to be funds that will have a limited number of institutional investors: in some cases, this is a function of investor interest, but it could be as a result of the fund manager arranging a 'club deal' (a fund created for specific identified investors) or operating segregated mandates (a segregated mandate is a fund run exclusively for a particular investor, typically an institutional investor). In such cases, the fund manager would typically earn far lower fees than for running a pooled fund. We therefore agree with the suggestion in the Consultation that the non-close test be adapted so that it can nevertheless be met when the reason for the Fund being closely held is because of the participation of qualifying investors. We consider that the definition of qualifying investor should be based on that used for the purposes of Schedule 5AAA TCGA. We suggest that the legislation sets out the list in full (rather than cross-referencing other provisions) so the regime can be understood on a stand-alone basis, and that a power to add to the list is reserved. It is particularly important that other (widely-held) funds are

able to qualify as 'good' investors for this purpose: it could be challenging (even if possible) for a Fund to obtain detailed information about ultimate investors in another fund.

(11) The Consultation asks about other uses of AHC that could be considered for inclusion within the regime. As referred to above, the nature of the underlying assets of debt funds means that co-invest can generally be achieved through co-lending (i.e., the Fund and co-investor each hold a participation in the same loan), rather than an investor holding a direct stake in an AHC. For an institutional investor, we note that it is likely that they would set up a single purpose company to be co-lender, with that company's investment in the loan likely to have been made on the basis of advice from the fund manager (that advice is likely to be provided to the institution, but there could be a contract with the AHC itself). We consider that an AHC set up by as single institutional investor (a qualifying investor) for this type of co-investment should be within the scope of the regime: the nature of the institution would evidence pooled investment, and the institution is advised by an independent manager. An adapted non-close test, together with the definition of institutional investor, should allow the government to manage the risk of the regime being accessed inappropriately for 'private' benefit – if the government still had concerns that this could lead to institutions accessing the AHC exemption in relation to 'own account' lending platforms, then a condition around co-investment could also be included.

(12) Although it is not common for an investor to invest directly in a Fund's AHC, we consider that this should be provided for as practice in this area can change – and provided that the conditions are designed to protect the Exchequer, we consider risks could be mitigated: for example, there could be a requirement that there is (i) otherwise a qualifying fund vehicle (i.e. CIS or AIF) invested directly or indirectly in the AHC; and (ii) a clear commercial objective/purpose for the investor in question to invest directly into the AHC (for example, a joint venture, parallel investment or co-investment).

(13) We also note, for completeness, that some institutions have in recent years set up CRE finance platforms. The institutions, generally insurance companies, are investing on behalf of policy holders and so there is a 'pooling' of funds in the context of the funds managed by the institution. They are subject to financial regulation. In many cases, management will be in-house, by specialist teams. But in some cases, the arrangement may involve outsourcing management to an independent fund manager. Here, the manager is advising generally, rather than on a specific co-invest.

(14) Given that, taking account of the policy objectives, there could be various alternative arrangements potentially within the scope of the regime, we agree with the suggestion in the Final Response Document that there may need to be a number of alternative tests. In addition, there should be a power to extend the regime to other structures: this would offer flexibility and recognise the need to take account of market and other developments in the alternative fund sector.

*Management*

(15) For CRE debt funds, the fund manager will generally be regulated and independent of its investors, whose interest in the Fund will be 'passive' (i.e., they would not have "day-to-day control").

(16) The fund managers would generally have a carried interest in the Fund and/or 'skin in the game'. In general, this would be at Fund level (allowing account to be taken of overall investment performance). Any "independence" requirement as between investors and manager should recognise that such an interest is likely (and so for example if a connection-type test is used, the UK tax rules that can deem all partners in a partnership to be connected would need to be disapplied/adapted).

(17) Given the potential for a fund manager to agree a different arrangement for a specific investment (including where it is advising on a co-invest), we consider the regime should also cater for situations where the fund manager has an interest in the AHC as part of the arrangements for management incentives. As this is not common, we cannot comment on what would be an appropriate maximum proportion.

(18) Where an institution sets up an AHC to be able to co-invest in a CRE financing with a Fund, then that institution would have control over its subsidiary AHC – although management decisions around the investments made would have been delegated to the manager. In such cases, an "independent capacity" may be more appropriate.

*Activities*

(19) In its Final Response Guidance, the government says it is considering including a condition that an AHC should not carry on a trade (and possible ways of testing that condition, given that trading is a question of fact normally assessed by reference to actual activities).

(20) We do not consider such a condition by itself to be helpful. Whilst we understand the government's concern, the distinction between "trade" and "investment" in relation to many of the asset classes that AHCs would invest in is not clear-cut. There are a number of grey areas – and hence, for example, the 'white-list' in relation to the investment manager exemption. A 'no trade' condition may therefore be difficult to apply in practice, even with a "reasonable to suppose" test – which will require a fund manager to assess whether what it anticipates the AHC will be doing falls into one category or the other. We consider that it may be appropriate instead to consider options for structures where the analysis does not fall clearly into one category – and debt funds are an example where this could be relevant. We note, for example, that the securitisation regime prescribed qualifying activities, without imposing a 'no trade' rule.

(21) A CRE debt fund will generally use its investors' capital to advance loans which it intends to hold to maturity. Unlike a classic securitisation vehicle, a debt fund will generally be originating loans (HMRC practice historically has been that securitisation companies that acquire debt to hold to maturity are investment companies). This difference by itself does not mean a debt fund is trading. The activity should be respected as an investment activity. This needs to be made clear.

(22) Even though the underlying loans are held on a medium to long term 'hold to maturity' basis, there may be situations where the assets are replaced. For example, assets may be sold prior to maturity if: (i) there is an event of default under the terms of the underlying asset (in which case the Fund may assign the loan rather than itself engage in working it out); (ii) there is an unanticipated event or circumstance which means the loan ceases to meet the Fund's investment criteria; or (iii) in response to economic uncertainty resulting from unexpected events. Each of these examples is a response to an external stimulus (and so they are not for the purpose of realising a 'short-term' (trading-like) profit and so we consider that, absent any specific trading patterns or strategy, the replacement of assets in itself should not generally change the nature of the activity from investment to trading. These types of activity also therefore need to be permitted within the regime. One possibility could be to allow some (limited) flexibility to 'churn' investments – this could for example be by reference to a safe harbour for a certain % of the investments within each accounting period (the % being set by reference to market expectations for different types of funds).

(23) A Fund may employ various strategies, whether to enable it to secure an investment opportunity or to enhance investor returns. These may be used in limited cases only, because of the individual facts of a particular financing, or could be part of a general approach. Two particular examples of these are set out below.

(a) Example 1: A debt fund focuses on mezzanine finance. An opportunity may arise where a borrower is looking to obtain senior and mezzanine finance. Timing and other circumstances mean that the Fund, to obtain the opportunity, advances both types of finance, with the aim of finding a buyer for the senior tranche within a reasonable period of making the loan (senior lending is not part of its strategy). In some circumstances, this may involve the advance of a single loan, and so a senior tranche is 'created' before being sold on. The sale of part of the loan is because holding the full loan does not meet its objectives, and not for the purpose of making profit from syndication.

(b) Example 2: A debt fund makes a loan to a borrower. To boost yield, taking account of the return that investors are expecting based on its investment strategy, it funds the loan through a mix of investor capital and bank debt (for a period matching the term of the loan). The purpose of this is to boost returns: the bank finance is not because the Fund wants short-term finance pending sale (the intention remains to hold to maturity).

(24) We consider that such activities should be permitted within the regime. A 'no trade' test means the Fund would have to consider the 'badges of trade' and work how they might apply to the actions that may be taken. Although managers could be assisted by guidance (as is the approach taken by the securitisation company regime), guidance may not necessarily address all possible situations, is subject to change and is not binding on HMRC – which means it is not an optimum solution. We therefore support the suggestion made in the Final Response Guidance to look to applying a form of the existing whitelist of investment transactions set out in regulation 2 of the Investment Transaction (Tax) Regulation 2014 (SI 2014/685) to AHCs.

(25) In addition, any eligibility criteria around activity needs to accommodate the possibility of the CRE debt fund needing to take enforcement action should a borrower default. This could involve an AHC (not necessarily the lending AHC) acquiring shares in the borrower, taking steps to 'work out' the loan and finally selling the borrower/underlying property in order to recover amounts due under the loan. Such activity does not necessarily give rise to trading risk, but could cause other issues, depending on how the criteria is written. (Under the securitisation regime, the securitisation vehicle cannot hold shares and so this type of action is not possible.) An AHC must have the commercial flexibility it needs when considering enforcement action without its tax status under the regime being at risk.

(26) Finally, to avoid cliff edges, and a disproportionate monitoring burden, we would welcome a buffer for non-investment activities that are incidental or non-material within the eligibility criteria for the AHC regime (we note there is precedent for this in the securitisation regime).

(27) The above comments relate to classic CRE debt funds. An NPL fund operates differently – in particular it acquires assets with a view to being able to improve their value, through working out the debt or perhaps a restructuring, so that ultimately the loan is repaid by the borrower at a higher amount as compared to the amount paid for it on the secondary market. That can generally be achieved over the short to medium term. Repayment may be on contractual maturity or earlier, depending on the type of action required. AHCs set up by NPL funds still carry on a "facilitative, intermediate role for genuine commercial reasons" and so should be within the regime. As mentioned above, for completeness, it is recognised that there may be funds that acquire non-performing debt with a view to on-selling at a profit – but our comments are directed at those NPL funds that use their CRE expertise to ensure repayment at closer to par than the purchase price implied (a 'pull to par' arrangement).

(28) The Consultation references other possible criteria linked to ensuring AHCs can only be used for their intended purpose. Given the lack of eligibility criteria in other possible AHC jurisdictions, we suggest that criteria focus on the key issues identified by the Consultation. Conditions relating to amount and usage of capital may impact commercial flexibility: in addition, capital and investment objectives are set generally at Fund, not AHC level (and will be met with regard to the entirety of the Fund's investments, not just those held by the AHC). If, as the Final Response Guidelines suggest, the government is concerned with ensuring that the AHC is part of an arrangement that genuinely pools different investor's capital, we suggest that an alternative test is considered.

***Profit on income (Qs 15-19)***

(29) The purpose of the new AHC regime should be to allow an AHC to achieve (effective) tax neutrality: i.e., to put the investor in the same or as close as a position as if they had directly invested in the Fund's underlying assets.

(30) Overall, we agree that the taxable profit of an AHC should be proportionate to its role. In the context of CRE debt funds, given the activity undertaken by an AHC is often nominal in relation to the performance of the investment (in most cases return will be by reference to income (interest) on lending activity as most loans will repay at par on maturity), we would not expect the retained profit to have to also be other than (effectively) nominal – this would be commensurate with this low level of activity while also consistent with purpose and substance standards under OECD principles.

(31) We agree that the level of profit should therefore be determined by reference to transfer pricing principles but note that it will be important that an AHC can determine the applicable level with a high degree of certainty that HMRC will not challenge – and that, for CRE debt funds in particular, that there will (at least) be published information/guidelines that will assist the AHC determining the relevant amount (given the nature of the CRE debt fund investment model, applying transfer pricing rules should be made as straightforward as possible). As the Consultation says, "the complexity of an AHC''s transfer pricing should be limited". We agree with the suggestion made by respondents to the initial consultation that a measure based on a return on lending volume or on cost would be appropriate here. However, in determining the appropriate methodology, account needs to be taken that the AHC is also likely to receive fee income under the loan (for example, arrangement fees and commitment fees) and an early prepayment may result in a redemption premium being paid (or swap termination costs if the AHC is party to a related derivative).

(32) Assuming transfer pricing is the determinant of profit level, the regime will need to make adjustments to the plethora of UK tax rules that can restrict interest deductibility: As summarised above, where an AHC is set up in Luxembourg as an SV, although it is in general fully subject to corporate income taxes, all interest, dividends and other distributions made to the holders of the SV's issued securities constitute deductible items for corporate income tax purposes, effectively achieving SV tax neutrality.

(33) The Consultation says that: "Provided the AHC follows a practice of returning such amounts to investors, it should be able to obtain relief against its taxable income without significant volatility" and proposes allowing tax relief for interest paid on results-dependent debt (subject to transfer pricing).

(34) We welcome this suggestion: here, the use of profit participating loans by a Fund to finance AHCs is common practice (given the flexibility they provide, both in terms of returning money to investors but also accommodating all returns). This is particularly the case for NPL funds where the amount of the return that may be realised on a particular loan is unquantifiable at acquisition. Disapplying this particular limb of the distribution rules will therefore allow a Fund to continue to use this established practice to finance UK AHCs. We therefore agree with the comments of respondents to the initial consultation on AHCs as summarised in sections 2.42 to 2.51 of the Consultation.

(35) But the regime will also need to adapt other UK rules restricting relief for interest such as; the corporate interest restriction (particularly as they apply to related party debt); anti-hybrid rules and (depending on the facts) other "distribution" provisions (e.g., limiting relief to a "reasonable commercial return"). These are all relevant when determining the "taxable profit" of an AHC.

(36) In terms of corporate interest restriction in particular, we assume that an exemption is unlikely (we note that securitisation companies are technically subject to the rules, with any potential adverse impact effectively overridden by the retained profit provisions). If this is correct, we would suggest that each AHC is looked at individually (i.e., a single-member worldwide group). Generally, a lending AHC should (in practice) be in a net interest income position, but there may be situations where this is not the case – whether on a temporary or longer term basis. To address this, one possibility would be to allow full deductibility for debt meeting certain criteria (following the approach taken in the public infrastructure exemption) and/or shareholder profit participating or other loans that fund the AHC to be taken into account when working out QNGIE (within the group ratio).

(37) In terms of anti-hybrids, we agree with the comments made by respondents to the initial consultation as set out in sections 2.113 to 2.114 of the Consultation. The UK anti-hybrid rules are complex and

require fund managers to spend a considerable amount of time and resources to consider the impact of such rules and so we welcome the government's willingness to make amendments to these rules to address hybridity resulting from the AHC, as well as the recently announced changes to those provisions following last year's consultation.

(38) The Consultation highlights the importance for some AHCs of treaty eligibility. For a CRE debt fund, treaty eligibility will be relevant if the borrower source jurisdiction imposes withholding tax on interest (which many EU jurisdictions do not). Given the importance of minimising withholding taxes because of the tax neutrality objective, we agree that the new regime should allow AHCs to be eligible for double tax treaty relief. However, the regime should not be prescriptive as to what an AHC should do in this regard – for those AHCs that do not need to access treaty benefits (which would include those that focus on the UK CRE market only), additional conditions designed by reference to HMRC's view of 'substance' would be inappropriate: the regime needs to accommodate and not dictate particular substance requirements.

***Capital gains/loan relationship 'capital' profits realised by AHC (Qs 20-22)***

(39) We welcome the government's view that AHCs should not pay tax on capital gains on disposals of investment assets. Whilst in general an AHC owned by a CRE debt fund would not be within the scope of CGT (as their assets would mainly be loan relationships and so profits and gains are brought into account as income whether income or capital in nature), we consider this to be appropriate in policy terms. (We comment at (53) to (55) below on the position of an NPL fund that realises a loan relationship 'capital' profit on its assets.)

(40) CGT may however be relevant to an AHC owned by a debt fund if, as a result of enforcement action, it acquires the borrower group. Here, the relevant AHC would be expected to pay a minimal amount for shares in the borrower. Exit could involve the borrower selling its property and repaying the debt, or the AHC selling the borrower holding the property (possibly in conjunction with a debt refinancing). SSE is unlikely to be available under its current formulation as the borrower is unlikely to be a trading company: in addition, the shares may not have been held for the relevant period. If the borrower is a property unit trust or similar vehicle (common in the UK CRE sector), then the units would not be share capital in any event. If the borrower owns UK land, given that it would not itself be an AHC (and so would remain in the charge to CGT on a future disposal), we consider that any gain on a sale of the borrower should be exempt. This would suggest a non-SSE CGT exemption is to be preferred in these circumstances.

(41) We would also ask that the government consider an exception to the indirect disposal of UK land rules (or at least a reversion to the 25% substantial indirect interest in land condition) where an investor in the Fund, through a results-dependent loan to the AHC, could be regarded as holding an interest in a UK property-rich company in such a situation. Here, the investment strategy is to obtain returns from lending activities – not to profit from real estate itself – and if the loan to the borrower was vanilla arm's length debt (which it will generally be), it would seem inappropriate that intra-Fund complex arrangements could bring Schedule 1A TCGA into point.

***Withholding tax on payments of interest to investors (Qs 23-24)***

(42) We welcome the government's exploration of providing for a withholding exemption for AHCs. We agree with the comments made in sections 4.91 and 4.92 of the Consultation.

(43) Interest on debt is a key mechanism for repatriating returns to investors. The use of an AHC in a CRE debt fund is not to secure a withholding tax advantage for a particular investor: it's simply to minimise tax costs as they impact the returns of fund investors overall (to provide effective tax neutrality).

(44) Although the UK has a number of withholding tax exemptions that could be available to allow an AHC to pay interest on financing from the Fund without withholding, these are administratively cumbersome and (in relation to quoted Eurobond status) involve cost (in relation to listing costs). Where treaty

applications are made, there are timing issues given the need to either file DTTP2 forms or await a treaty direction. There has also, from time to time, been uncertainty around the quoted Eurobond exemption given past consultations and other matters. Further, the definition of "excepted payment" in section 937 Income Tax Act 2007 means that any UK corporate investor in a Fund that is a partnership will not be entitled to exemption from withholding tax if any of the other partners are non-UK residents entitled to exemption under the terms of an applicable double tax treaty.

(45) We therefore consider a specific exemption for payments by AHCs should be included within the regime. We consider that an absolute exemption should be given to payments to any third party lender to the AHC, with conditions (if any) only applicable to loans made by the Fund (or an investor, as an investor, separately) to address the risks the government has highlighted as concerns here (i.e., income being diverted to low tax jurisdictions).

(46) If conditions are to apply to interest on shareholder debt, these conditions should be factual in nature so that the AHC can readily confirm whether they are met or not: we therefore do not consider a purpose test appropriate given the subjectivity involved, creating uncertainty. Further, taking account of the withholding position in other jurisdictions, we would suggest that there should be a general exemption available to all payments other that those made to investors located in specific listed jurisdictions and/or received by entities that are owned by investors in such jurisdictions (i.e., a form of blacklist). This would provide certainty for AHCs that withholding is or is not applicable in particular circumstances.

(47) In addition, there may also be improvements that could be made to facilitate access to existing exemptions. Where a treaty passport is to be used, for example, relief could be conditional on the investor being named in the HMRC DTTP Register (so there is no need for filing the DTTP2 before interest can be paid gross). Further, modifications could be made to the qualifying private placement exemption that would enable it to apply as between the Fund and the AHC (assuming the Fund's investors meet the applicable criteria) – this may mean the minimum £10m condition should be relaxed for AHCs.

(48) Any withholding exemption should equally be applicable to other annual payments made by an AHC.

***Income and gains paid to investors (Qs 25-31)***

(49) The government proposes in effect to characterise payments to investors in respect of returns from the Fund attributable to an AHC as income or capital by reference to their classification for UK tax purposes. As returns to investors could be made by either payments under shareholder debt (whether interest, discount or principal) or share repurchases, we generally agree that the regime should guard against rolled-up interest income being returned by way of capital gain on a share repurchase.

(50) For a classic CRE debt fund, returns will generally be income for corporation tax purposes (as interest, fees or redemption premium under loan relationships). Capital gains as such are unlikely to arise in practice for such funds – save if a particular loan provides for an equity-linked feature (whether a minority equity holding, for example in the form of an equity kicker, or a profit-linked repayment premium where the underlying property is sold at a gain) or as a result of enforcement.

(51) This means that classic CRE debt fund's profile in terms of this aspect of the regime is likely to be much more straightforward than that of other types of alternative fund (where returns are more mixed). We therefore suggest that the regime recognises the different types of fund, and allows for simplified tracing for those Funds for which returns are almost exclusively income: the loan relationship rules had the consequence of removing an income/capital distinction in relation to corporate debt and on that basis rules intended to prevent people exploiting that distinction should not be relevant. This is because the type of tracing regime outlined in the Consultation has the potential to be administratively complex, particularly if returns are not immediately returned, but re-invested – and for a debt fund with returns primarily (if not wholly) derived from income, the concerns the government has around converting income to capital are not relevant. Although for an individual AHC, the administrative burden may not be material, the Fund will need to be tracking returns from all its AHCs, including those not in the UK (or

in the new regime) to be able to identify when (and the extent to which) returns from AHCs are being distributed to investors We would therefore suggest that the government take a pragmatic approach here with a streamlined arrangement for such funds.

(52) Similarly, given the concerns relating to the position of UK investors in a fund, we would suggest that a simplified tracing model also apply where there are no taxable UK investors (or a de minimis number): for closed ended funds, the investor class would be generally static. This would mean that a Fund with investors who are either exempt or non-UK resident does not have to comply with administrative requirements that are directed at ensuring UK taxable investors are not looking to obtain tax benefits from AHC investment.

(53) The above relates to a "lending" CRE debt fund. As the government acknowledges the position for NPL funds is more complex. The return is linked to improvement in recovery under a debt: this relates to the principal due under the loan, and (ignoring tax classification) in substance represents a capital return on funds invested. Under the loan relationship rules it is taxed as income. If it is returned to investors as either interest on profit-participating debt or as a redemption premium on shareholder debt, UK investors would generally be expected to be taxed on income (under the deep discounted securities rules or the loan relationship provisions).

(54) We therefore consider that the regime should characterise the loan relationship "income" profit on NPLs as capital, not income, in terms of its tax treatment when received by investors. We appreciate that the government has concerns as to how to quantify the "capital" amount to prevent income (i.e., interest on the underlying loan) being converted into capital. In practice, such funds are likely to be tracking receipts (with interest income generally paid out when received) and so one possible option would be to impose a requirement on such funds to pay out interest income received (whether during the life of the loan or as part of the final repayment amount) within a particular period of receipt, providing a level of assurance that it is not being retained in the AHC to be paid out as 'capital' redemption premium. The amount returned to investors representing 'profit' on principal repayment would then be regarded as giving rise to a capital gain for the investor. To obtain capital treatment for UK individual investors, the deep discount security rules (which would apply to the shareholder debt, but not to the underlying asset) would need to be disapplied.

(55) In terms of the treatment of the AHC itself, we consider the most straightforward approach would be to retain the classification as profit under the loan relationship rules and allow a deduction for payments in respect of that profit made by way of interest/premium under shareholder debt. Subject to the profit level within the AHC set by reference to its activities, this would mean that the AHC would be 'flat' (and the AHC taxed no differently from any other UK company on its debt holdings), and investors (if in the UK) taxed on the profit as capital (individuals) or loan relationship profit (corporates). This would, as the Final Response Guidelines highlight, require amendments to be made to the distribution rules dealing with non-commercial and special securities. The consequence of this would be to enable all payments on the shareholder profit participating debt to be deductible (subject to the margin) – which would assist in achieving effective tax neutrality.

(56) This is, however, subject to one caveat. In those cases where a loan made by an AHC includes an equity-linked element that is designed to provide the AHC with an additional return calculated by reference to a capital gain realised on a sale of the underlying property or the property-owning company, we consider that such a return should be capable of being classified as capital gain in the AHC. Although any such amount would form part of the AHC's overall return from its lending activity, and so forms part of its overall yield, by its nature, it is not 'income' (in particular, unlike redemption premia payable on early redemption, it is not compensation for loss of future interest yield). Any such gains should therefore be permitted to be repatriated to the Fund and investors in a capital form.

***Stamp duty and SDRT (Q 36)***

(57) We consider a stamp duty exemption for share repurchases by an AHC is required given that this is a route for returning income and gains to investors. Tax should be a neutral factor in deciding how to return monies to the Fund (and investors) under the new regime: repayment of debt would be free of stamp duty and so a repurchase of shares for the same economic/commercial purpose should similarly be stamp duty free.

(58) We also consider that transfers of shareholder debt issued by the AHC should be exempt from stamp duty. Often the Fund is a partnership and stamp duty can be charged on the transfer of partnership interests (and similarly SDRT may be chargeable) where the partnership holds shares or marketable securities. The results-dependent debt would be outside the current loan capital exemption – and therefore whether stamp duty is chargeable will depend whether the loan is capable of being listed (based on a definition in an 1891 Act). A similar issue arises in relation to shares held by a partnership Fund in an AHC given paragraph 33 Schedule 5 Finance Act 2003. Absent an exemption from stamp duty for transfers of shares and loan capital in an AHC, a non-UK investor in a (say, non-UK) Fund is potentially liable to UK stamp duty or SDRT. This contrasts unfavourably with the position in other AHC jurisdictions where no transfer taxes would be payable.

(59) We understand from discussions at recent meetings that the government has reservations as to providing an exemption from existing stamp duty charges given concerns as to the revenue that would be foregone. In that context, as noted by attendees on the call, if a Fund was, overall, attracted to use a UK AHC, it would be possible to incorporate an AHC outside the UK but ensure it was UK tax resident so that UK stamp taxes would not impact investors. In this context, we would note that this was the approach taken in relation to a number of securitisation companies pending the capital markets adaptation of the loan capital exemption being introduced.

(60) In relation to the question as to whether an AHC may be sold, for CRE debt funds with the strategy of holding the loan to maturity, a sale of an AHC is unlikely. However, should a Fund be considering divesting itself of a particular loan, it would consider all possible ways of effecting the sale, and it is possible that in some cases it may make sense to transfer the AHC rather than the loan (for example, if the borrower jurisdiction imposes significant transaction costs on transferring the loan/related security as compared to a sale of the AHC itself). Where an AHC is 'single purpose', a sale of the AHC would be feasible in such circumstances.

(61) We also consider that the loan capital exemption should be amended to remove from the charge to stamp duty (and SDRT) loans and interests in loans acquired by AHCs. A CRE debt fund will generally originate, but it could also acquire a loan on the secondary market (where say a bank makes the loan, with the Fund taking a participation). A NPL fund will only be buying loans on the secondary market. To determine if stamp duty is chargeable will require due diligence of the terms of the loan by reference to both the 1891 test of marketable security and the conditions of the loan capital exemption (not just at the point of acquisition, but at all times from when it was originated). Where an NPL fund acquires a portfolio of loans from an original lender, this is a time-consuming exercise – particularly in relation to the potential for the loan terms to include a provision that means that could be results-dependent interest (given the wide scope of s79(6)(b) Finance Act 1986).

***Corporate groups (Qs 37-38)***

(62) We broadly concur with the government's position set out at section 4.139 of the Consultation, provided that (a) AHCs do indeed benefit from additional deductions/reliefs; and (b) each subsidiary company which sits under an alternative fund (or an eligible AHC) is itself capable of being an AHC or more generally benefitting from the AHC tax neutrality regime.

***Entry/Exit from the AHC regime (Qs 39-43)***

(63) As stated above, we consider existing AHCs should be able to benefit from the regime. We agree that it would be sensible for a new accounting period to start on joining the regime.

(64) No other comments.

***Other tax issues (Qs 44-46)***

(65) The Consultation does not deal with VAT issues, which will be the subject of a separate consultation. As a general comment, however, we ask the government to consider providing for VAT zero-rating to apply to management fees if and where these need to be charged at the level of the AHC.

(66) We have highlighted issues around the corporate interest restriction and the distribution rules elsewhere in this response.

(67) Securitisation regime: In principle we agree that a new regime for AHCs is preferable to broadening the specialist securitisation regime to provide the flexibility required by credit funds. However, this is subject to the detail of the proposed AHC regime. In addition, we ask that, when the detail of the new AHC regime has been finalised, the government reviews the securitisation regime to identify if any changes are needed in light of the policy decisions made for AHCs to ensure the securitisation regime remains competitive.

***Reporting and monitoring (Qs 48-49)***

(68) We acknowledge the government's need to obtain information from AHCs on an annual basis both to check on compliance and also to allow it to assess if it is achieving its policy objectives.

(69) Any reporting requirements need to be clearly set out in legislation: this links to the Fund being in a position to obtain, if relevant, information about investors to comply with UK obligations.

(70) Given the different fund models in operation, there should not be a 'one size fits all' approach: the information should relate to the tax profile of particular funds. It would also be helpful if the rationale for particular information could be explained, and would encourage the government to work with asset managers to minimise the need for separate and specific tax-information measures being needed, over and above information in existing systems for reporting.

We hope these submissions are helpful. If you have any questions or would like to discuss further, please contact Sarah Squires on ssquires@crefceurope.org in the first instance.

Yours faithfully

**Peter Cosmetatos**
**Chief executive, CREFC Europe**

**E pcosmetatos@crefceurope.org**
**T 07931588451**