Investment Property Forum

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Tax treatment of asset holding companies in alternative fund structures

The Investment Property Forum (IPF) welcomes the opportunity to respond on the above consultation.

IPF is a national membership organisation of senior professionals, all active in the property investment and finance market. The organisation has a diverse membership of over 2,000, which includes fund managers, investment agents, accountants, bankers, lawyers, researchers, academics, actuaries and other related professionals.

The IPF's Mission is to enhance the understanding and efficiency of property as an investment, including public, private, debt, equity and derivatives, for its members and other interested parties, including government. The IPF's scope covers direct and indirect routes to investing in property. With regards to the latter, we have an Indirect Property Interest Group that covers issues relating to both the listed and unlisted property sector.

We are not a lobby organisation but one of our key priorities is to identify where legislation or regulation has, or will have, an impact on the market and to alert government and our members to any adverse or beneficial issues.

Responses to questions 1-9

Question 1: What role do AHCs perform within alternative fund structures? What are the commercial and tax benefits of using AHCs within alternative fund structures, and what advantages do they offer versus direct investment?

As outlined in the Consultation Document, there are several commercial reasons for using AHCs between a fund (or other investment vehicle) and its underlying investments. It is important to note that a fund may own multiple different AHCs performing different functions. Some AHCs may be 'Special Purpose Vehicles' (SPVs) to hold specific investments whilst others may to be hold some, or all, of a fund's SPVs and investments. This is discussed in more detail in our response to question 2.

We would make the following additional specific points:

a) The Consultation Document mentions that AHCs may be used to limit liability of investors in a fund. SPVs to hold specific underlying investments or grouped pools of investments may also be used to limit liability between investments, particularly where debt is used to fund underlying investments.

b) An AHC may be held by more than one fund. This may be between unrelated funds in a joint venture situation but may also be between closely related funds. For example, a fund manager may have an AHC that is established to hold its European investments that is 70% held by its 'European' fund and 30% by its 'global' fund. A 'fund' may also be made up of different vehicles, for example different partnerships for different types of investor or denominated in different currencies. An AHC allows the investments to then be pooled together.

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The tax considerations mentioned in the Consultation Document are also extremely important. The funds themselves are typically in the form of vehicles that are tax exempt or more often tax transparent. This raises a number of practical tax issues. Accessing the benefits of double tax treaties may be difficult administratively, not all investors will be eligible and by owning a small interest via a fund will restrict the access to the most beneficial double tax treaty provisions. Depending on the nature of the fund (see our response to question 2 below), the investors may change over time.

Equally from the perspective of the investors, looking through to the underlying investments can make their own tax filing obligations highly complex.

Interposing an AHC that is a taxpayer in its own right can often address these issues.

Question 2: To what extent are AHCs prevalent in other funds or pooled investment structures?

Our response to this question is in respect of our area of expertise, i.e. real estate funds, but funds to invest in other asset classes may also face the same challenge.

We believe that there is a mismatch between the proposed definition in 2.7 and the more detailed description in 2.8 and 2.9. The definition in 2.7 refers to the OECD concept of non-CIV funds. This has been used in the context of the OECD Base Erosion and Profit Shifting (BEPS) Action Plans. The OECD term 'CIV' is limited to funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established, with a non-CIV fund being a fund that is not a CIV. This gives a very broad definition of non-CIV funds. For real estate, funds may be open-ended, closed-ended or some hybrid of the two, and the vehicles themselves take a wide variety of forms of which a limited partnership is one, but certainly not the only, vehicle. This Consultation Document was framed in the Budget as being part of a broader consultation on the UK funds environment. UK real estate industry bodies have already proposed the introduction of a new investment vehicle for professional investors that is based on an Authorised Contractual Scheme rather than a limited partnership. The AHC rules should reflect the broad range of funds for which this might be relevant.

There is an open question here as to why AHC rules, if adopted, should only be available for AHCs owned by funds. If it excludes joint ventures and similar arrangements, then managers will continue to default to Luxembourg and elsewhere.

There are also other forms of investment product that are not in the form of funds as defined that use AHCs, such as life insurance companies, pension funds and sovereign wealth funds. Facilitating investment from such capital sources through the UK asset management industry via AHCs even if not in the form of a fund is very much in line with the policy objective set out in the Consultation Document.

If it is felt necessary to restrict this to funds, it would be preferable to adopt a very broad definition, such as that of a Collective Investment Scheme in section 235 of the Financial Services and Markets Act (FSMA) 2000.

Question 3: What do you consider to be the main fiscal and economic benefits to the UK – _both direct and indirect - of greater AHC domicile? Can you support this with any quantitative evidence?

We agree with the analysis set out in 2.13 to 2.17 of the Consultation Document. Unless specifically indicated, our response to this question is broader than real estate.

The direct tax benefit is likely to insignificant compared to the indirect benefits as set out in the consultation.

In considering the potential economic benefits for the UK, we have looked at economic data for Luxembourg, which is the leading jurisdiction for fund-owned AHCs.

In 2017 (the latest year for which comprehensive data is available) Luxembourg GDP[1] was $62,449m, representing a three-fold increase in 20 years. Luxembourg GDP in 2017 comprised:

agriculture:	0.3%
industry:	12.8%
services:	86.9%

Financial services accounted for more than 25% of GDP. Investment management is a very significant component of this. Luxembourg has the largest Assets Under Management (AUM) in funds in Europe and is second only to the United States globally. Total AUM in funds in Luxembourg[2] of €4,483bn (as at May 2020), have grown from €875m since 2000[3]. The UK is fifth in Europe with AUM of about a third of that of Luxembourg.

In addition to the 25% of GDP attributable directly to financial services, it is a key driver for the other components of Luxembourg GDP. Much of the broader service sector (discussed further below) provides services directly and indirectly to the financial services sector. Its growth has also been a key driver of the construction boom in Luxembourg. In 2017, construction was the largest component of 'industry' in the GDP analysis accounting for 5.4% of GDP.

Luxembourg's economic success also contributes indirectly to neighbouring countries' GDP. Nearly 50% of the Luxembourg workforce commutes in daily from other countries, mainly Germany, France and Belgium[4].

Of the total AUM in funds in Luxembourg[5] of €4,483bn, €88bn is in real estate funds (320 funds) and €105bn is private equity/venture capital funds (628 funds). Each fund may own multiple AHCs. Furthermore, Luxembourg is a location for AHCs for funds located elsewhere. For example, many US funds use Luxembourg AHCs to hold their European investments.

The use of Luxembourg AHCs in real estate and private equity structures has been a development since the mid-1990s.

The most direct service to AHCs is from administration firms setting up and operating the entities. There are a large number of providers in Luxembourg, and we estimate the total revenue of the Luxembourg administration market at circa €750m[6].

Based on information obtained from administration service providers, we think the very rough split of administration services across the industry as follows:

Funds	30%
AHCs owned by funds	40%
Other	30%

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[1] OECD, STATEC
[2] ALFI (Association of the Luxembourg Fund Industry)
[3] EFAMA
[4] STATEC
[5] ALFI (Association of the Luxembourg Fund Industry)
[6] *Estimate based on data from Luxembourg Alternative Administrators Association (L3A) plus interviews with administrators.*

The key services provided are:
Company formation
Corporate and legal support services
Domiciliation (registered office services)
Provision of directors
Accounting and tax
Regulatory compliance
Payments processing
Transaction processing
Cash management
CIS / FATCA reporting
Statutory filings

Changes to the international tax environment and the need to demonstrate greater commercial substance to structures have been a major driver of two significant changes:

a) There is an increased tendency to locate the fund and the AHCs in the same jurisdiction. This is discussed further below; and

b) Fund managers with AHCs in Luxembourg are increasingly taking in-house activities that have traditionally been provided by administrators, hiring staff to cover this and other areas[7]. Twenty years ago, it was highly unusual for a private equity or real estate fund manager with AHCs in Luxembourg to have any employees of their own. The largest private equity and real estate fund manager now has over 280 employees in Luxembourg for its real estate activities alone, all employed by its AHCs. The manager had no Luxembourg employees 20 years ago. Managers, who we spoke to in conducting our research for this response to the Consultation Document, also noted that as a result of the largely tax-driven requirement for greater substance, the seniority of their employees based in Luxembourg has also increased, with obvious benefits for the local economy.

Of more significance than the direct services of setting up and operating AHCs is the broader impact on the professional services market.

PwC[8] is the largest professional services firm in Luxembourg, with 3,000 employees at the start of 2020 and revenues in 2019 of €464m, broken down as:

Tax	31.4%
Statutory audit	30.9%
Advisory	24.8%
Other services	12.9%

This is broken down by industry as:

Real estate	17%
Private equity	13%
Other financial services:	43%
Operational companies:	21%
Public sector	6%

Fee revenues in Luxembourg for PwC alone for real estate and private equity in 2019 were therefore €193.8m.

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[7] Information provided by fund managers
[8] PwC annual report

The other ‘Big 4’ accounting firms also have large operations in Luxembourg (Deloitte revenue €350m, EY revenue €236m, KPMG revenue €232m) and a number of mid-tier firms are also represented.

As with the accounting profession, Luxembourg has extensive representation from major law firms. In the words of Legal 500, *“In light of the country's aforementioned primacy in the funds sphere, as well as the jurisdiction's importance in relation to the structuring of big-ticket M&A mandates, it is not surprising that in spite of its small size it hosts an inordinately large collection of major international law firms”.* The legal market is more fragmented than the accountancy market and the participants are less forthcoming with published data. It is not, therefore, possible to estimate the economic impact.

Both the accounting and law firms benefit from often complex transaction-related activity conducted through the AHCs.

Another key area of service provision is banking. Investment transactions and the flow of income through the AHC creates a need for banks to service that activity. At the end of 2018, Luxembourg had 136 banks, from 28 different countries. 16% of activity is investment fund servicing and 20.5% is corporate banking[9].

If the AHC can be located in the UK, there is a better case for the fund that owns it to also be based in the UK, to meet tax obligations. The changes to the international tax environment as a result of the OECD Base Erosion and Profit Shifting (BEPS) Action Plans are discussed further in the response to question 6 below.

Again, looking at the example of Luxembourg, there has been a significant growth in the number of managers establishing both the fund and the AHC in Luxembourg. Luxembourg has introduced new fund vehicles such as the SCS and RAIF to facilitate this.

Encouraging the domicile of funds in the UK would bring additional fiscal and economic benefits. We have not commented on this in detail, but as mentioned in our response to question 2, it is important to consider this also in the context of the broader fund consultation announced in the Budget.

It is also important to note that the increasing tax and other pressures to locate the fund and AHC in the same jurisdiction creates a threat to the UK’s current fund industry. An increasing number of managers are setting up funds in Luxembourg that would historically have been established in the UK.

Based on the analysis undertaken, we would suggest a conservative estimate of private equity and real estate funds’ contribution to the Luxembourg economy of 5% of GDP, half of which is directly attributable to AHCs. This suggests a contribution to Luxembourg GDP of €1.5bn to €2bn.

Question 4: For each of the fund classes identified in Chapter 3, what are the different challenges that the UK tax rules create for the establishment of AHCs in the UK? Are there any other fund classes for which similar challenges arise?

As the IPF, our focus is on real estate. However, we believe that infrastructure investment should also be considered as it has many similarities to real estate as an asset class. Many investment managers invest across real assets (real estate and infrastructure) as a combined business.

From a real estate perspective, there are two broad challenges:

a) The use of AHCs to hold UK real estate; and

b) The use of AHCs to hold overseas real estate.

[9] PwC report, “Banking in Luxembourg, 2019”.

In both cases, additional tax cost in the AHC that results in the investor being taxed when they would not otherwise be (i.e. tax-exempt investors such as pension funds) or taxed twice, the AHC regime becomes unattractive and an AHC in another jurisdiction will be used.

We have not provided a technical analysis of UK law in this area but understand that the Association of Real Estate Funds (AREF), the Law Society and others are providing detailed commentary in their responses.

Question 5: How are the challenges to locating an AHC in the UK, to the extent that they exist, currently overcome? How do the tax rules in other countries address these challenges?

The challenges of locating an AHC in the UK are generally overcome by fund managers simply by using a different jurisdiction, most often Luxembourg for real estate AHCs.

Widely used jurisdictions for AHCs, such as Luxembourg and the Netherlands, have two key features of their tax regimes compared to the UK:

a) A more comprehensive participation exemption regime with fewer restrictions than the equivalent UK rules. This provides exemption from tax on capital gains and dividends from portfolio companies. In the context of real estate, this would generally be local, real estate-owning SPVs; and

b) No withholding taxes on interest payments.

To be competitive with Luxembourg as an AHC regime, the UK would need to provide a tax regime that does not come with a significantly greater tax cost or complexity.

The complexity of UK tax rules is a disincentive to locating AHCs in the UK for two reasons:

a) The cost of compliance is higher; and

b) It creates less certainty as to tax treatment. This is a major issue for investment funds, as certainty over the value of assets and liabilities and the net distribution to investors is crucial.

Question 6: What impacts have recent developments in the international tax landscape had on determining where to locate an AHC? How have asset management firms so far responded to these developments?

Changes in the international tax landscape in response to the OECD Base Erosion and Profit Shifting (BEPS) Action Plans has accelerated changes that were already taking place. As outlined in our response to question 3, this has two broad impacts:

- There is an increased tendency to locate the fund and the AHCs in the same jurisdiction; and

- Fund managers with AHCs in Luxembourg are increasingly taking activities that are provided by administrators in-house, hiring staff to cover this and other areas.

The changes to the tax landscape should encourage managers to locate the funds and AHCs in the jurisdiction where the manager has its main business operations. If a suitable fund and AHC regime can be created, this would encourage funds and AHCs to be located in the UK. If not, there is likely to be greater pressure on UK-based managers to locate more business functions where the funds and AHCs are located, e.g. Luxembourg. This pressure will increase after the end of the Brexit transition period as many managers will want to locate funds in an EU jurisdiction to benefit from the passporting regime for marketing under the EU Alternative Investment Fund Managers Directive (AIFMD).

Question 7: To what extent are there non-tax barriers to AHCs being located in the UK? If so, how might these dilute the impact of reform to existing tax rules intended to improve the UK's attractiveness as an AHC location?

As outlined in our responses to questions 3 and 6, there is an increased tendency to locate the fund and the AHCs in the same jurisdiction. The greatest non-tax obstacles to locating the AHC in the UK are likely to be regulatory issues that make it less attractive to locate the fund itself in the UK.

There are two key issues:

a) As outlined in our response to question 6, after the end of the Brexit transition period many managers will want to locate funds in an EU jurisdiction to benefit from the passporting regime for marketing under the AIFMD; and

b) There is a lack of choice of suitable UK fund vehicles. The Investment Association has provided proposals for a Long-Term Asset Fund and AREF for a Professional Investor Fund.

The broader fund consultation announced in the Budget will be key.

In general, fund managers attach great importance to stability, predictability and clarity in both tax and non-tax considerations.

Question 8: How could the challenges identified under Question 4 best be overcome?

We have not provided a technical analysis of UK law in this area but understand that AREF, the Law Society and others are providing detailed commentary in their responses.

Question 9: Do you consider that there is a case for the government to develop specific rules concerning the tax treatment of asset holding vehicles in alternative fund structures? What could those rules look like? How should eligibility be defined for qualifying fund structures and the AHCs within them?

We have not provided a technical analysis of UK law in this area but understand that AREF, the Law Society and others are providing detailed commentary in their responses.

Please do contact me should you wish to discuss any of the above in further detail.

Yours sincerely,

Sue Forster

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