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5 November 2015

Dear Josh

SDLT seeding relief for property authorised investment funds and co-ownership authorised contractual schemes

As you know, AREF strongly supports the introduction of a stamp duty land tax (SDLT) seeding relief for property authorised investment funds (PAIFs) and of clarification of the SDLT treatment of and seeding relief for co-ownership authorised contractual schemes (CoACSs).

AREF also recognises the government's concern that any seeding relief for PAIFs or CoACSs should not create opportunities for tax avoidance. However, for a seeding relief to be effective, it must be framed appropriately, as must any anti-avoidance (such as clawback) provisions. For example, we consider that seeding relief should be available on an amalgamation into one fund of portfolios owned by unrelated investors.

The SDLT exemption for an initial transfer of propety to a unit trust scheme was repealed by Finance Act 2006 in response to tax avoidance. We would like to draw a distinction with possible seeding reliefs for PAIFs and CoACSs. Both PAIFs and CoACSs are authorised funds and subject to UK regulation. This minimises the risk that they may be used to avoid SDLT.

On the whole, we do not consider that clawback provisions would be a significant impediment to using PAIFs and CoACSs. However, there are some important points to be considered to ensure that clawback is effective but does not inhibit the use of PAIFs and CoACSs. These include:

- the virtual impossibility of seeding an existing property portfolio on a single occasion
- the need to use feeder funds for PAIFs
- potential distribution of shares in a PAIF or units in a CoACS by a life company to policyholders
- a potential clawback would make pricing of a unitised life policy impractical (if not impossible) which would be a major deterrent for many life companies considering seeding a PAIF or CoACS with property.

We consider that it should be possible to factor these into the design of a seeding relief and clawback provisions whilst not increasing the opportunity for tax avoidance. You can find more detail in Appendix 1.

There is a statutory clearance service to check that the genuine diversity of ownership condition will be met prior to entry into the PAIF regime. It would be very helpful if this service could be extended to confirm that seeding relief will be available. Such an advance clearance service would similarly be helpful for CoACSs. Property funds are typically highly risk averse.

We are pleased that HMRC appears committed to link in with Revenue Scotland in relation to any proposed changes. Many existing funds have property located in both Scotland and the rest of the UK. This means that introducing SDLT seeding reliefs for PAIFs and CoACSs without introducing equivalent reliefs from land and buildings transaction tax (LBTT) is unlikely to be workable.

Finally, we would like to reiterate our offer to comment on draft legislation prior to it being made publicly available. Such a review would be aimed at ensuring that the legislation will be effective in practice whilst meeting the policy criteria.

If you require any further information, please feel free to contact me.

Yours sincerely

John Cartwright
Chief Executive
The Association of Real Estate Funds

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Appendix 1

Stamp duty land tax: rules for property investment funds

These notes relate to the HMT/HMRC consultation document "Stamp Duty Land Tax: rules for property investment funds" *(the "ConDoc") and to the proposed seeding relief for certain property funds.*

The ConDoc dealt with two types of property funds: property authorised investment funds (PAIFs) which are a form of open-ended investment company that qualifies for and has elected into the PAIF direct tax regime, and co-ownership authorised contractual schemes (CoACSs).

References in these notes to funds relate both to standalone funds and to sub-funds in the case of umbrella funds, not to the umbrella as a whole, and references to Chapters are to chapters of the ConDoc.

Our comments are in two parts:

- *the general SDLT treatment of CoACS investors (except seeding)*
- *seeding relief for PAIFs and CoACSs (which we have taken as one except as indicated).*

SDLT treatment of co-ownership authorised contractual schemes (Chapter 4)

The proposals in Chapter 4 appear to be both reasonable and practicable, provided that an appropriate seeding relief is also provided to allow property portfolios to be transferred from existing owners into new CoACSs in exchange for an issue of units and in a commercially viable manner.

Comments on Chapter 4

<u>Step 1: Introduce a new exemption from SDLT which would otherwise arise from transactions in units of a CoACS</u>

This would remove a major obstacle to CoACSs being used for property funds.

It is important that this is achieved by way of an exemption and does not deem there to be a change in the nature of the units for SDLT purposes. In other words, the units should remain interests in the underlying property and so, in principle, subject to SDLT, but benefit from a special exemption. Any other approach may call into question the essential fiscal transparency of the CoACS structure.

<u>Step 2: Change the responsibility for paying SDLT from unitholders to the scheme operator</u>

This is also useful and desirable administratively but (again with the need to preserve fiscal transparency) the legislation should be drafted on the basis of making the operator the agent for the unitholders and as such liable to pay SDLT ***on behalf of the unitholders*** to HMRC on purchases of scheme property and to complete the necessary SDLT forms. Correspondingly, nothing must prevent the operator from paying the SDLT from the scheme property ie, effectively from the participants in proportion to their interests.

Step 3: Introduce an SDLT charge on CoACSs acquiring property from connected parties

This needs to be carefully drafted, but we accept that it is necessary to prevent step 1 from creating avoidance opportunities. The SDLT charge should be expressed as being on the market value of any property made subject to the scheme in exchange for units. There should be no charge on the scheme (which is technically impossible as it has no legal standing) but, rather, a charge on all the participants (as with step 2). The scheme operator would be liabile to pay to HMRC as the particpants' agent and to complete the necessary SDLT forms.

(Consequently, where a person contributes property to a CoACS, it will be deemed for SDLT purposes to have disposed of its entire interest in the property and repurchased a share of the property commensurate with its proportionate holding in the CoACS immediately following the transaction.)

Step 4: Introduce a seeding relief for CoACSs fulfilling certain criteria

This should exempt the operator (acting as agent of the scheme participants) from having to account to HMRC for SDLT on the acquisition of property in the circumstances where the seeding relief applies.

Please see below for comments on the clawback of relief from founder participants who make early disposals of units received in exchange for property.

Seeding relief from SDLT for property investment funds (PAIFs and CoACSs with the objective/policy of investing in property)

Seeding property funds

It is normal for a seed investor to provide the initial property portfolio for a property fund. This is necessary as it is rarely possible now to attract investors to a fund without an existing portfolio (often called a blind fund). It is also very common for a property fund to exist for a period with only its seed investor(s) to enable it to build up a track record to take to the market when it is publicly launched.

The ConDoc envisages the seeding relief applying to property portfolios initially held by a single person or by group companies which are transferred into the fund in a single transaction.

Transactions requiring tranches

It is frequently not commercially practicable to transfer a substantial portfolio in a single tranche. Some of the seed portfolios for PAIFs and CoACSs are likely to be of a size requiring them to be broken down into several tranches. (There are currently two property ACSs with portfolios of roughly £2bn each, and these both required several tranches as the various institutions' systems could not handle transferring several hundred properties at one time.)

Unrelated seed investors and restructuring existing funds into PAIFs or CoACSs

The ConDoc does not propose an amalgamation of a number of portfolios owned by unrelated investors into one fund. This could theoretically be achieved by each portfolio being used to seed a separate fund and those funds then being merged, but this seems unnecessarily complex. We therefore suggest there should be an exemption which is set out in Case 2 below.

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We are aware of a number of existing property funds that may wish to restructure into a CoACS or PAIF. They typically have unrelated investors. The suggestion in Case 2 below would enable them to convert using a seeding relief. Alternatively, there could be a de minimis provision for third party holdings, as there is in group relief. Logically the figure would mirror the 25% group relief figure.

We suggest that where property is held as part of a portfolio by one or a (possibly limited) number of seed investors or groups of companies then it should be possible to contribute that property to a fund without an SDLT charge providing that each seed investor or corporate group owns a share of the aggregate number of units at the end of the seeding period proportionate to their original holdings. There would be partial exchanges of beneficial interests in properties between investors, but each investor would retain a property investment of the same proportionate value.

The rationale for permitting such transactions to be SDLT-efficient is both to encourage the initial pooling of property for efficient management but also, where significant property portfolios already exist, to permit them to be pooled in a fund where this does not involve an overall change of economic ownership. The fund could then be used to manage the existing portfolios more economically and/or could serve as a basis for expansion of the overall portfolio by attracting new investors.

Ways in which seeding relief for a transfer of properties to a PAIF or CoACS could work

Case 1

This is similar to the approach proposed in the ConDoc but allows for seeding over a period.

We suggest that seeding relief apply to all property transactions where the seed property is initially owned by one person or by group companies and is transferred to a PAIF or CoACS within a prescribed period. The period would run:

- from initial receipt of property by the fund
- until immediately before shares/ units in the fund are first acquired by a third party investor.

(The position is similar to a group of companies holding properties directly, where group relief prevents any SDLT arising on intragroup transfers. Unless this is thought to be a policy error, then it would appear that where a fund is inserted into the arrangement then so long as the shares/units remain held within the corporate group there is no SDLT charge. Any transfer of shares/units between the group companies would be exempt from SDLT but, if there were no exemption, would benefit from group relief.)

The benefit this gives is that the economic benefit of pooled rights/pooled ownership is obtained without the administrative complexity of large numbers of group relief claims (which the current online SDLT form system is not geared up to do). On the administrative level, there are currently major practical issues with submitting SDLT forms for large portfolios. The seeding of an existing property CoACSs required an administrative easement to facilitate the filing, effectively allowing one SDLT form to be completed online showing the total value but relating to only one property with the information for the other properties submitted by post. This skewed HMRC's figures for statistical purposes. Also it took a very considerable amount of time and expense to produce the occupational leases information required because it was not needed for the seeding transaction itself.

It would be helpful to have the opportunity to seek advance clearance that seeding relief would be available in a Case 1 scenario. Reasons include the highly risk averse nature of property funds in general, and the size of transactions likely to be significant.

Case 2

Case 1 would apply for a CoACS or PAIF seeded by a single group of companies, and thus would be helpful for very substantial institutional investor groups. However, Case 1 does not assist a CoACS or a PAIF in getting started if the initial property portfolio must be put together in other circumstances such as by several unrelated investors. As mentioned above, the result could be achieved by each investor seeding a separate CoACS or PAIF and then merging them (technically using takeovers), but this seems an unnecessarily complex and expensive process. We therefore suggest that seeding relief should apply in a second circumstance.

As for Case 1, it would not be practicable to transfer all seed properties into the fund simultaneously.

Case 2 envisages a number of unconnected investors coming together and agreeing jointly to seed a new CoACS or PAIF. We suggest that seeding relief apply to all transfers of property by these investors to the PAIF or CoACS within a prescribed period. The period would run:

from

- an initial receipt of property by the fund

until immediately before the first of:

- a cash purchase of units/ shares by a third party (non-seed investor)
- a contribution of property in exchange for units/ shares by a non-seed investor
- a disposal (whether by way of a transfer or redemption) of units/ shares by a seed investor.

There could be a time limit to prevent the seeding period lasting indefinitely. For example, this could be at least two years which would allow a track record to be established.

For the same reasons as in Case 1, it would be helpful to have the opportunity to seek advance clearance that seeding relief would be available.

Possible extra conditions for Case 2

- Advance clearance by HMRC could be mandatory for any planned Case 2 seeding. (We would not expect these to occur so often as to have resourcing implications for HMRC.) This would help to address any avoidance concerns HM Treasury and/ or HMRC might have in relation to making seeding relief available in a Case 2 scenario.

- The property intended to be contributed could be identified within the proposal put to HMRC. Seeding relief would then be limited to that property. (If for some reason any intended properties were not contributed, this should not affect relief on the remaining properties which were contributed. It is very normal for a planned list to be cut back when particular problems arise eg, a landlord not consenting to an assignment of a lease in time, or a depositary not accepting a property because of environmental risk).

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Possible general conditions for seeding relief

It has been suggested that genuine diversity of ownership (GDO) be a condition for the availability of seeding relief.

A PAIF must satisfy the GDO test but there is currently no requirement for a CoACS to do so. Several of the current CoACSs may not strictly be able to meet the test being essentially 'life company group only' CoACSs, though they are providing the underlying investments for very large numbers of life and/ or pensions policies.

Ideally, the GDO test would be a condition for seeding relief, accepting that life insurance long term funds are effectively held for many policyholders. Alternatively meeting the GDO test at the end of the seeding period would be a requirement for the relief. (There could be a possible clawback of seeding relief if the GDO test was not met).

Alternatively (or as well) a group only CoACS could be allowed to exist indefinitely provided that it had no third party investors or put in place changes to meet the GDO test on first admitting third party investors. This would also have the advantage of avoiding any need for giving pre-existing property CoACSs an advantage over later ones.

The ConDoc suggested possible minimum sizes of portfolios for seeding. As a general principle, we cannot see why any minimum size of portfolio above that already needed for a PAIF or REIT should be required (subject to the points in the paragraphs below). It is in the operator's interest to gather the largest seed portfolio available as any further acquisitions by the CoACS/ PAIF would incur an SDLT charge.

We consider that minimum portfolio sizes would inhibit start-ups. However, it is understandable that the government would not wish to see a fund used as a wrapper for holding unitholders' /shareholders' personal homes and would require rules to prevent this.

Clearly the government would not want the special rules deterring enveloping of individual or small numbers of residential properties to be undermined in any way. We note that a foreign collective investment scheme is exempt from CGT on gains on UK property providing that it satisfies the GDO test. It would therefore seem that limiting the relief to a UK fund that satisfies the GDO test should give sufficient comfort. If it is, however, considered necessary to prescribe that the initial portfolio(s) contributed to the fund contain a minimum number of dwellings, it is important that the number is commercially realistic. We suggest 10.

It is possible that the use of residential property by persons connected with the CoACS/PAIF could be prohibited although the drafting of this would need consideration. In a larger residential property fund, for instance, the operator is most unlikely to know the identity of all but the largest investors. If a fund were designed to hold residential property for the investors' personal use, the operator would know all about it.

In the case of commercial property a minimum portfolio size could mirror the REIT rules ie, be expressed as substantial interests in at least three properties.

The ConDoc mentions an avoidance test to deny relief in a case where the property contributions were part of a scheme with a main purpose of avoiding SDLT. If this is considered necessary, it should be drafted to avoid catching normal commercial arrangements to create and seed a fund.

Seeding relief clawback

The ConDoc proposed a clawback arrangement to prevent avoidance of SDLT. This could otherwise happen if property were acquired by a third party buying units/ shares in a CoACS or PAIF from a seed investor where seeding relief had been claimed. The ConDoc suggested that sales of units/ shares within a three-year period could trigger clawback. A three year period would be in line with clawback of SDLT group relief.

The relief should only be clawed back in respect of the number of shares/ units by which the seed investor's holding (or the seed group's holding) drops below the number of shares/ units received by that investor or group for its initial seed contribution (ie, the number of units in respect of which relief was received) during the clawback period.

Any clawback should be as simple as possible. The amount of any clawback should be (at most) the amount of seeding relief received which is proportionate to the units/ shares disposed of by the seed investor (or group). Clawback should possibly be fixed at the amount of SDLT relief at the time of the property transfer to the PAIF/ CoACS. (There could be a reduction if the value of shares/ units had dropped below that initial value at the time of disposal). The seed investor would then have a fixed maximum provision to make against the value of its initial shares/ units which could be released on expiry of the clawback period.

The ConDoc stated that the liability for any clawback would lie wholly with the seed investor that had disposed of its seed units/ shares. If a clawback is considered necessary then we would support this as any SDLT advantage would benefit the seed investor. It is important that the CoACS/ PAIF does not have a secondary liability for the SDLT. If there is concern about collecting the SDLT clawed back, it may be appropriate to give the operator responsibility for collecting it by deducting the amount from the proceeds of redemption by the seed investor. In order to ensure that the burden of any clawback falls only on the seed investor making the disposal, the operator should not be able to recover any clawback from, or charge any clawback to, the fund or investors in general.

Feeder funds for PAIFs

One of the rules for PAIF status is that no corporate investor may hold 10% or more of the net asset value of the PAIF (to prevent possible treaty abuse). Consequently if a company seeds a PAIF, the company will have to exchange the shares it receives for units in the (authorised unit trust) feeder fund. Where a PAIF has a feeder fund (and the vast majority, if not all of them, do) then the clawback should apply to a seed investor whether it holds PAIF shares or feeder fund units, and the clawback should not apply to the feeder fund itself.

We include in Appendix 2 a typical step plan with timings for conversion of an authorised unit trust to a PAIF. This has been kindly provided by Eversheds LLP.

Distribution of shares in a PAIF or units in a CoACS by a life company to policyholders

Life insurance policies have traditionally been used as method of long-term saving (including pensions). Life companies own the assets but transfer the risks and rewards of ownership almost entirely to the policyholders.

Solvency II requires life companies to hold much increased regulatory capital. To avoid the cost of the increased regulatory capital some life companies are moving away from issuing policies to their customers to using collective investment schemes managed by the insurer instead. This is happening where the assets are securities or bonds.

However, where the assets under management are UK property then this potentially involves a transfer of beneficial ownership, which would be subject to SDLT. There is, however, no economic change of owner as the risks and rewards of ownership remain with the (former) policyholder, for example a pension fund, and the likely term of ownership of the replacement units or shares by the policyholder is not likely to be any different to what it would have had it been a life policy. In other words, the next sale and purchase transaction (by the fund) on which SDLT will be due is likely to be the same as it would otherwise have been.

Currently a policyholder can exit from their policy without suffering any charge in respect of SDLT. (The life company may well continue to hold the assets.) Similarly, in normal circumstances, a holder of units or shares in a property collective investment scheme can redeem them without an SDLT charge. In both cases, when the life company or collective investment scheme requires cash or wants to sell a property for investment reasons, the purchaser bears an SDLT charge.

In circumstances where units in a CoACS or shares in a PAIF are distributed to former policyholders then we consider that it would be inappropriate (as well as potentially impossibly complex) to apply a clawback of the SDLT relief proposed to be given on transfer in to the fund. It would appear that the timing of the next direct property transaction (albeit now by the collective investment scheme rather than by the life company) is unlikely to be affected by the transfer of the property from the life company to the collective investment scheme.

It would be appropriate for any anti-avoidance provision to apply if a transaction is part of an arrangement to avoid SDLT or to avoid a clawback in relation to a property transaction that would still have taken place and would otherwise have incurred SDLT.

We suggest an exception from any clawback for disposals by life companies to policyholders in exchange for the surrender of policy rights.

Unitised life policies

Where an insurance company's long term fund issues unitised policies and the insurance company contributes the property underlying the unitised policies to a CoACS or PAIF then the possibility of a clawback leads to very considerable difficulties in the unit/ share pricing.

The prices of the CoACS's units or PAIF's shares would not reflect any potential clawback (as this would be a liability of the insurance company seed investor and not of the CoACS/ PAIF investors generally). However the notional or shadow units within the insurance company fund (ie, the quantum of the policyholder's entitlement) would need to reflect the potential clawback in the underlying units/ shares' selling price – so that if any policyholder received a policy payment in the period of the clawback (whether by switching from property to another asset class or by the policy terminating) a reduction may have to be applied in respect of an SDLT charge on the units/ shares redeemed in the CoACS/ PAIF. There would, in many cases, be a major practical difficulty in pricing any contingent clawback amount into the notional units.

In the scenario where the life company's book is closed, so that there are a fixed number of notional units in existence at the time property is contributed to the CoACS/ PAIF and no more policies or notional units will be issued, then the amount of the potential clawback will be fixed and so pricing it in would be possible. (It seems inequitable to penalise exiting policyholders in this way when the benefit of pooling the portfolio will generally be greater for the longer term policyholders remaining.) However, it would be very unusual for a book of business to be closed to the extent that existing policyholders could not continue contributing to their policies.

Normally a life company's book is open, or at least open for existing policyholders. This means that the number of notional units backing policies may be fluctuating day-by-day. (The move from defined benefit to defined contribution pensions should lead to increased demand for unitised property policies.) In this case, pricing the potential clawback into policy units would become impractical (assuming it operates on a last in, first out basis, which would generally be the equitable approach) because it would not be possible to allocate it correctly to the policy units. To add to the complexity many life companies are corporate groups with more than one issuing unitised policies. Given that there is no potential for the life company to manipulate sales of units/ shares in the CoACS/ PAIF, we ask you to consider an exemption from the clawback for unitised long term insurance funds.

Alignment of clawback of seeding relief with clawback of group relief

Logically seeding relief and clawback of seeding releif should be aligned with group relief and clawback of group relief. This would result in no clawback of seeing relief in respect of the first 25% of disposals of seed units/ shares.

Life companies' profits portfolios

Life companies sometimes have to rebalance their non-unitised portfolios for reasons beyond their control. For example, their regulator might require this (as the FSA has done in the past). It would be harsh for this to trigger a clawback.

Tax transparent schemes established outside the UK

Position of investors in foreign funds

In order to comply with EU legislation, the changes listed at Steps 1 to 3 in Chapter 4 of the ConDoc may need to apply to any fund that is transparent for tax on income and which is equivalent to a CoACS but established offshore. We note that there is already similar treatment for unit trust schemes (including those deemed transparent for tax on income) at FA 2003 section 101.

We would happily work with HMRC to determine what "equivalence" means in these circumstances. Examples may include an open-ended Luxembourg FCP. Ultimately it would be helpful to have a "white list" in guidance.

Position of foreign funds as regards seeding relief: equivalence

We recognise that seeding relief would be restricted to qualifying property funds and that a foreign fund would qualify only if it was equivalent to a qualifying UK fund.

However, where UK investor's investment in a foreign fund is closely comparable to a UK investor's investment in a UK property specialist fund, the government will need to consider how SDLT (and any seeding reliefs) should apply to UK investors in such funds when they hold UK situated land and buildings.

This analysis, relating to seeding relief, may be different to and more restrictive than that which simply determines opacity for any CoACS for SDLT purposes and which is discussed above. We would be happy to assist with this second analysis where the conditions for seeding relief would be in point.

It seems unlikely that any foreign funds will have sufficient similarity to a UK PAIF to be able to make a close comparison.

Assuming that the SDLT regime for CoACSs and the seeding relief for both CoACSs and PAIFs are extended to comparable foreign funds, it would also be necessary to consider how SDLT could be collected on any clawback. One possibility would be to put a provisional charge on the property where relief had been claimed and then release it when the clawback period has expired.

Both CoACSs and PAIFs are FCA authorised. Any fund established abroad would presumably only qualify for seeding relief if it were regulated in a similar manner.

Grandfathering of existing CoACSs

We are aware of two property CoACSs which have already been seeded not relying on any form of seeding relief. Logically the clawback provisions should not apply to them and it would be helpful if this could be confirmed, possibly in the guidance.

Capital gains tax

There is also now a CGT charge on residential property for non-UK residents and, where any of the investors is non-UK resident, the operator of a CoACS or a foreign equivalent could potentially be within scope for this. The ConDoc recognised this and suggested that CoACSs that satisfy a GDO requirement be exempt from this charge. This is already the case for UK property owned by foreign collective investment schemes similar to a CoACS.

Lack of an SDLT relief for mergers of property funds generally

A final point, unrelated to the ConDoc, is that there is currently no SDLT relief for mergers of authorised property funds (other than on converting or merging an authorised unit trust containing property into an OEIC, which was introduced to facilitate existing property funds moving to PAIF status) equivalent to the reliefs from SDRT and stamp duty (part statutory and part HMRC practice in HMRC's SDRT Customer Newsletter No. 7) available for the merger of securities funds. Currently property fund mergers are achievable, but with some practical and regulatory difficulties, by having the continuing fund make a general offer to the holders of the target fund, and when it has acquired the units/ shares in the target fund, winding it up.