AREF
The Association of Real Estate Funds

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Association of Real Estate Funds

The Association of Real Estate Funds (AREF) represents the UK real estate funds industry and has 67 member funds with a collective net asset value of more than £70 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the MSCI/AREF UK Quarterly Property Funds Index and the MSCI/AREF Property Fund Vision Handbook.

Our Response

Executive Summary

AREF welcomes moves by the European Union to disincentivise tax avoidance and evasion and supports proportionate and well considered Directives that seek to discourage and penalise those actors who are seeking to undermine the tax base of Member States.

AREF does consider that the "Proposal for a Council Directive laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU" ("The Proposal") released on 22nd December 2021 may be unnecessarily broad and may inadvertently capture legitimate investment structures that facilitate collective investment in real estate (and certain other asset classes).

We welcome the opportunity to share our concerns with you and have made constructive suggestions to ensure that the Proposal is focussed on those seeking to unfairly erode the tax base of Member States and does not inadvertently damage an important part of the Union's investment market. From the express exclusions provided for in the Proposal it is clear that there is an intention to exclude well-regulated Funds from the provisions of the Proposal. However, the drafting of the proposal may unintentionally exclude certain types of investment fund structures from accessing the exemptions.

For this reason, we consider there is a clear case to amend the Proposal in three critical ways:

1) To expand the derogation in Article 6 paragraph 2 to include undertakings wholly or almost wholly, directly or indirectly owned by one or more investment funds;
2) To include consideration of the activities carried out by the management company of an investment structure, or its affiliates, in the test under Article 6(2)(e) when considering the level of substance of an undertaking that is a direct or indirect subsidiary wholly or almost wholly owned by the investment structure; and
3) To include premises occupied by the management company of an investment structure, or its affiliates, as satisfaction of the test under Article 7(1)(a) and that the "own premises" or "premises for exclusive use" is considered to be applied at the level of the management company and not at the level of separate undertakings that are subsidiary to the investment structure in question.

We believe these, relatively minor, amendments will seek to ensure that the Proposal does not artificially create a situation where real estate investment funds, whose corporate structure is driven by the asset class rather than by a tax avoidance motivation, are discriminated against compared to other investment asset classes.

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We provide further details below as to why we believe there is a reasonable case to support these changes.

Background

AREF fully agrees that it is important for tax authorities to ensure that artificial structures which are established to take inappropriate advantage of tax legislation are targeted and where tax benefit has been unfairly obtained such benefits are denied. However, AREF has serious reservations around the breadth of the Proposal. The Proposal as presently drafted brings concerns that a large number of structures which are not established for the purposes of utilising shell companies to avoid tax will be caught by the provisions, or will not be capable of being exempted. There is a significant risk that legitimate business structures are considered to be shell entities as a consequence of the application of the provisions of the Proposal without appropriate consideration of the underlying business model of the respective investment structure and whether there is an overall tax avoidance motivation.

The Proposal states that:

"Existing tax instruments at EU level do not contain, however, explicit provisions targeting shell entities, i.e. entities that do not perform any actual economic activity, even if they are presumably engaged with one, and that can be misused for tax avoidance or evasion purposes."

This clearly suggests that an entity that is a shell entity according to the Proposal is almost by definition being misused for tax avoidance or evasion as a consequence of limited economic activity. We would strongly argue that for certain investment activities an entity can be very legitimately engaged in an economic activity even if the human and physical resources of the entity are limited. We note that the Proposal acknowledges that facts and circumstances will determine whether a potential shell entity is actually a shell entity and provides the opportunity for rebuttal of the assumption but we remain concerned that the initial "at risk" classification will result in economic damage to the investment structure even if it is subsequently found not to be a shell entity following due consideration.

Real Estate Fund Structures

A real estate fund is a form of investment fund that is designed to pool investment from a number of investors (usually unconnected) with a policy of investing in a portfolio of real estate assets (i.e. fixed properties including land and buildings), typically over an extended period, with a view to generating returns mainly comprising net rental income and capital gains. Pooling investments in this way allows investors to access larger assets than they could acquire individually, to spread their risk across a portfolio of assets, and to share the costs of managing the portfolio and transaction costs.

A real estate fund can take a number of legal forms and can either be 'internally managed' (i.e. employ its own staff to manage the real estate portfolio) or, more typically, is 'externally managed' by a specialist investment fund management company who is responsible for managing the real estate portfolio within the fund on behalf of the investors.

The corporate structure of a multi-jurisdictional real estate fund is typically driven by numerous commercial considerations including:

- the facilitation of debt financing
- ring-fencing of construction, development or other property related risks and liabilities; and
- local market considerations where the property is located.

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These considerations drive the use of multiple legal entities within a real estate fund often with limited operational resource requirement, meaning that the likelihood of such entities being at risk of being classified as a shell entity within the meaning of the directive must be high.

Specific roles performed by companies within a real estate investment fund structure include:

- Property special purpose vehicles (SPVs)
- Holding companies
- Financing companies
- Joint ventures, club deals and co-investment
- Vehicles established to benefit from real estate tax incentives

These roles and their commercial basis are discussed in more detail in the Appendix.

There are cases where a large investment institution (such as a pension scheme or sovereign wealth fund) may decide to appoint a third party investment manager to manage part of its investment portfolio – often due to the manager having a specific expertise such as investing in real estate. While the investment structure used in such cases would not be considered an investment 'fund', as it does not involve pooling, in other respects it is very similar to an investment fund.

We therefore respectfully suggest that it is not reasonable to consider that there is a "one size fits all" approach to the consideration of sufficient substance, even if that test is set at a low bar. Different asset classes and business models will require significantly different inputs of resources, both from a volume perspective as well as their nature. As described above, that nature of the ***asset class*** means that a real estate fund is likely to establish a large number of investment holding entities and the nature of the ***individual assets*** means these entities may not have a strong need for significant number of employees and own resources.

Tax Neutrality

Funds are often designed to attract as broad a range of investors as possible and in order to be successful in raising capital for investment fund need to be structured to deliver a return to investors that is comparable with investment directly in the underlying assets. Governments look to achieve this policy outcome by putting in place favourable tax regimes (tax transparency or exemption) which minimise the tax cost incurred within the fund and thereby help to deliver an investment return to investors as close as possible in amount to the net income and capital growth derived from the underlying assets. Investors will then pay tax according to their status in their country of residence.

The exception to this principle, in the case of real estate funds, is the tax typically levied (in some form) by the country where property is located, on property rental profits and capital gains, usually irrespective of the tax residence of the owner - in which case tax neutrality is achieved by ensuring that the tax paid is the same whether investment is direct or via a fund.

We welcome the fact that the proposed directive includes an exclusion for regulated financial undertakings, including funds that are subject to certain defined levels of regulation. This exclusion recognises that the directive should not impose a fiscal or compliance burden on funds, and is consistent with the tax neutrality objective.

In the OECD's recent report on the Pillar Two Blueprint, the definition of an Investment Entity (excluded from the minimum tax rate requirement) was extended to entities that are at least 95% (or 85% in some cases) owned directly or indirectly by one or more Investment Funds or Real Estate Investment Vehicles. This recognised the fact that such

entities are a fundamental part of an Investment Fund structure and that preserving the tax neutrality of Investment Funds requires also taking into account the entities through which they hold underlying investments.

We consider that the directive should include a similar exclusion, as set out further below.

Regulation

The investment fund industry is subject to a great deal of regulation, much of which is coordinated to ensure that the level of supervision and investor protection is consistent across the EU.

In particular, most real estate funds are subject to the Alternative Investment Fund Managers Directive (AIFMD) or the UCITS directive.

These regulations define detailed requirements for funds and in particular their managers as to their level of organisational capability and competence, recognising that key functions relating to governance and risk management generally sit with the manager and not with the fund. It is generally the manager of a fund that is required to have a significant level of substance in order to meet these regulatory requirements. Where functions are delegated, either to affiliates of the manager or to specialist service providers (such as fund administrators) this is also in accordance with regulatory requirements and subject to the oversight and responsibility of the investment manager.

However, for an externally managed fund the portfolio is managed not by employees or directors of the fund entities but by employees of the management company (or its affiliates). Therefore, it is typically difficult for entities owned by such a fund to meet the indicators of minimum substance. Accordingly, such entities are likely to be classified as 'at risk' of being a shell entity for the purpose of the directive.

Immediate impact of being classified "at risk" of being a shell entity

It is clear that the preamble to the Proposal considers that specific facts and circumstances of an undertaking is essential to consider in determining whether it is a shell entity and provides for the opportunity of rebuttal of the supposition. We welcome the opportunity for rebuttal by taxpayers as provided by the Proposal. Nevertheless from a practical perspective this may be too late to avoid legitimate structures from suffering the consequences of passing the gateway to being considered "at risk" of being a shell entity. This is because in many countries the access to treaty or directive benefits requires advance provision of evidence of eligibility for benefits e.g. a certificate of residence. The rebuttal process necessarily happens following the consideration by a domestic tax authority that a taxpayer is, or may be, a shell entity. It is generally the case that interest payments, for example, may arise on a quarterly or even monthly basis and therefore whilst the correspondence and consideration of rebuttal by a taxpayer is going on it is highly likely that they are de facto being denied the benefits of treaties or directives whilst simultaneously contesting the classification.

This is likely to mean that cashflows and returns to investors will be impacted throughout this period. This may be argued only to be a timing difference in the sense that if the rebuttal is accepted the entity may have the opportunity to make a retrospective claim (provided the domestic legislation of the jurisdiction levying the withholding tax allows it) but for a widely held real estate investment fund it is highly likely that the investor mix has changed during the period that the position was being clarified. This means that Investors who were invested during the earlier period may be permanently disadvantaged and see their returns unfairly reduced by virtue of the delay in determining the appropriate treatment.

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The impact for tax authorities should also not be underestimated. The directive as drafted would require very large numbers of low risk or no risk applications for rebuttal to be filed and reviewed, and this will require significant resources for tax authorities and likely result in large backlogs (exacerbating the timing issues for funds as described above).

It is therefore essential that affected structures are able to be excluded up-front wherever possible. We therefore set out proposed amendments to the Proposal in order to ensure such structures are able to access relevant exclusions from being considered "at risk" wherever possible.

Alternative to rebuttal – exemption

Depending on the way the provisions of Article 9 are adopted and applied in practice in Member States, it may be difficult in practice to rely on rebuttal of the presumption not to have minimal substance. Instead, it may be necessary to consider whether an entity can benefit from the Article 10 exemption on the basis that the shell entity's interposition does not result in a tax reduction.

This may be relatively simple for a company within a multinational group to demonstrate, since it can show that its parent company would have benefitted from a similar tax treatment without the interposition of the shell entity, for example by reference to its tax return showing that the income is taxed in the parent's home country, or by the parent establishing its rights under a double tax treaty are equivalent to those of the shell entity.

Issues for real estate funds

Widely held real estate funds are not designed or marketed with a view to promoting tax avoidance but are structured to allow portfolio investors to access real estate as an investment class. In order to demonstrate that a shell company's presence does not reduce the overall tax liability, it is likely to be necessary to demonstrate that each investor in a fund's tax burden is not affected. However neither the shell company nor the manager of the fund will have access to the investors' tax returns; and it can be difficult to demonstrate conclusively whether investors are entitled to treaty benefits. This is particularly a problem for widely held funds with many investors, especially those for whom the investor base is constantly changing.

Proposed amendments

The first proposed amendment below is an appropriate and, we consider, necessary mechanism for resolving many of the unintended consequences of the Directive for real estate and other investment funds by providing a gateway test exclusion for vehicles within Investment Funds.

The further amendments (2 and 3) are intended to apply in the context of investment products that are externally managed but do not fall within the proposed definition of Investment Funds. These may include for example 'funds of one' or joint ventures where one or a small number of large institutional clients (such as investment funds, pension schemes, sovereign wealth funds or local authorities) engage the expertise of a specialist investment manager to manage part of their investment portfolio through an externally managed structure.

1. Expansion of excluded structures definition

We welcome the exclusion from the rules for funds which are subject to suitable regulation as outlined in draft Article 6(2)(b). However, the directive as drafted will not allow subsidiaries of investment funds to benefit

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from the same exclusion which will lead to considerable cost and uncertainty for the reasons given above. This is a particular issue for real estate funds.

We consider that this can be achieved through an expansion of the exemption in Article 6(2)(b) for regulated financial undertaking to cover Investment Entities, howsoever established, wholly or almost wholly, directly or indirectly owned by one or more Investment Funds or Real Estate Investment Vehicles.

The definition of an Investment Fund, an Investment Entity and a Real Estate Investment Vehicle for this purpose should be the same as that used in EU Directive (2021/0433) implementing the OECD Pillar Two proposals, to provide consistency and certainty.

In addition, this would remove the presumably unintended incentive for certain fund structures to seek regulated status for wholly owned subsidiary entities which would otherwise not require regulation. This would reduce an unnecessary burden on both fund managers and financial regulators.

2. Interpretation of availability of human and physical resources

We understand the drivers behind the phrasing of the Proposal is to ensure entities not undertaking meaningful operational activity in their jurisdiction of incorporation are not able to avail themselves of the treaty / directive benefits of genuinely being present in that jurisdiction. The formulation of the Proposal however does effectively label certain business operating models as being “good” and others as “bad”. We would recommend that the typical investment management business model is considered in the formulation of the Directive.

In recent years many investment management houses have sought to develop their physical and intellectual presence in jurisdictions where their investment funds and products are based in order to develop solid bases of operation with the right levels of human and physical capital to support their activities and satisfy the needs of local regulators and tax regulations. Indeed, it has become an important aspect of completing investor due diligence on an investment manager that the manager is able to support the fact that they have genuine and meaningful substance present in the jurisdiction of operation.

For operational and organisational reasons however, this substance is frequently concentrated in the investment manager’s corporate structure rather than in the investment structure. This is partly owing to the operational logic in keeping employees in the same employing entity. This facilitates HR operations, employment law compliance processes and other employment related matters. It is very common that an investment manager may manage multiple investment funds and structures and it is not operationally practical or efficient to have an identical roster of employees located in each investment fund or structure. In addition, the presence of employees in the investment management structure is also influenced by the fact that the management company is typically subject to oversight by the local regulator and is required to demonstrate appropriate capability to undertake its regulated activity (as noted above). In many cases, the Directors of the investment vehicles managed by the investment management company will be supplied from this pool of employees, often supplemented with non-executive directors with additional requisite skills and expertise.

It is therefore illogical for the Directive to disregard the meaningful presence established by the investment management industry in such locations and to insist on the fact that an entity managed by a well-established

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and resourced investment manager can be considered a "shell" entity only for the fact that the investment manager has sought to centralise its Human Resources for justifiable reasons as set out above.

We would also note that the experience of the COVID-19 pandemic has shown that in modern business the location in which an individual sits is becoming less relevant to their ability to perform their role appropriately. It appears likely that remote working, both within and between national territories will become far more mainstream as a long term impact of the pandemic. This de facto evolution of working models means that attempts to link "good" behaviour in the context of the Shell Company consideration with physical presence will increasingly be an anachronism. We agree there is clearly further consideration of this trend to come from regulators and tax authorities however we would caution that it is not the right time to seek to influence these decisions by virtue of this proposed Directive. In addition, we can see that it could be argued to be contrary to the principles of freedom of establishment within and between Member States to require presence by virtue of this Directive to avoid being classified as a shell. We acknowledge that issues of tax residence remain the jurisdiction of national tax authorities it seems contrary to principle for this to be enforced at the level of a Directive.

We therefore propose that a potential shell entity will not be considered to be lacking human resource provided that a majority of its activities are carried out by employees of the investment management company or companies within the management company's group. This can be achieved by including employees of the management company (or companies within the management company's group) of an investment undertaking in the test under Article 6(2)(e) when considering the presence of "full-time employees" of an undertaking. Taking into account the relatively low level of day-to-day activities of typical undertakings within an investment structure, this would not require five full time equivalent employees on an exclusive basis for each undertaking within the investment structure, but should be appropriate to the needs of the management company, with due regard to the regulatory requirements.

3. Interpretation of availability of exclusive premises

A similar argument applies in relation to "exclusive premises". We would therefore additionally propose that we include premises occupied by the management company of an investment undertaking (or affiliates of the management company) as satisfaction of the test under Article 7(1)(a) and that the "own premises" or "premises for exclusive use" is considered to be applied at the level of the management company not at the level of separate undertakings that are subsidiary to the investment structure in question.

This exemption would more accurately reflect the realities of how the investment management business generally seeks to organise itself. If the Directive is left in its present form then we fear that it directly incentivises attempts to artificially "insert" substance into subsidiary vehicles that lacks meaningful commercial drivers simply to avoid the punitive implications of being caught by the Directive. This driver can be eliminated through the amendment proposed above which acknowledges the difference in the operating model.

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Appendix – some common roles of entities within multinational real estate fund structures

Property Special Purpose Vehicles (SPVs)

It is typical for a fund to hold large properties, or in some cases a group of similar or related properties, in a company structure. There are significant commercial benefits in doing so including:

- Facilitating debt financing by allowing a lender to take a security interest (charge) over both the property asset and/or the shares in the company, without the complication of additional properties and lending from other finance providers
- Ring-fencing of liabilities such that commercial risks associated with the property do not impact on other assets of the fund.
- Facilitating sale of the property through sale of the shares in the company. This may be particularly relevant in the case of a partial sale since it is straightforward to sell a proportion of shares whereas joint property holding is complex under most legal systems.

While the company will often be established and tax resident in the country where the property is situated, this is not always the case, particularly in the context of a fund which invests in multiple countries and where it makes sense to centralise the administration of the companies in the structure.

Typically the country where the property is situated taxes the income arising from immovable property, and typically also the capital gains arising from its disposal (whether by sale of the property itself or by sale of the company). Indeed, double tax treaties explicitly provide for this. As such it is unlikely that a property SPV, even if a shell company, would escape taxation.

For long-term real estate investment businesses it is typical that the underlying assets may be let on long leases and on full repairing and insuring basis meaning that day to day property matters are allocated to tenants under the terms of the lease. This essentially results in the situation where once an investment structure has been established there may be limited periodic involvement required at the level of the legal entity which owns the real estate asset or the holding entity which may hold the shares of the property owning entity. This implies limited business need for significant "substance" in the entity itself.

Holding companies

A real estate fund will usually include at least one, and frequently several, holding companies in their structure. These holding companies are established to hold the shares and make loans to property SPVs (or other holding and financing companies).

Having a holding company allows the fund to manage the property portfolio effectively in the interest of investors. For example it will receive income and sale proceeds from the property SPVs and determine whether to distribute these to the fund's investors or reinvest in new property.

Holding companies are sometimes necessary for financing reasons – for example where a property is financed with both senior and junior debt then while the senior lender has a charge over the property and the property SPV shares, the junior lender would take a charge over the holding company's shares.

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A holding company's activities are by their nature ad hoc and therefore do not necessarily require a substantial level of "substance". For example the company's Board may only need to make decisions when a property is bought or sold, or dividends are paid from the property SPVs.

Financing companies

As noted above, typically a property SPV is liable to tax in the country where the property is situated. While typically the financing for a property acquisition involves external lenders, this is often supplemented or replaced by lending from within the fund itself ("internal financing"), in addition to equity. This requires the use of an entity within the fund to act as a lender, described as a Financing Company.

While tax is frequently a factor in deciding to fund an SPV with loans rather than equity (to benefit from a tax deduction for interest and other financing costs), this does not represent artificial tax avoidance but is simply a mechanism to ensure that the tax cost of investing in a property is the same whether financing is provided from an internal or an external lender. Without such a mechanism, investors that use external borrowing would pay less tax than those that do not, reducing the ability of the latter to bid competitively for property on a level playing field. The constitutional documents of funds typically contain a limit on the amount of external borrowing that can be used, in order to ensure that the risks to investors are limited and deliver the intended risk-return profile of the fund, so it is not normally an option for a fund simply to switch to external funding.

Such internal financing is subject to transfer pricing and thin capitalisation requirements in each country, ensuring that internal financing is commensurate with external borrowing, often with specific limits (e.g. 30% of gross income) on the amount of related-party interest that can be deducted. Additionally countries sometimes impose withholding tax on interest payments. The use of internal financing for property investment is therefore well covered by existing tax rules.

Again, a financing company's activities may be limited and ad hoc in nature, depending on the number and regularity of loans it makes. It may therefore operate with relatively limited 'substance'.

Joint ventures, club deals and co-investment

A fund will often make an investment representing an interest of less than 100% of a property, in order to achieve a desired level of exposure to that asset without creating an unbalanced fund.

This is frequently through agreeing to a joint venture (JV) with another investor, which may be another fund, an exempt institution such as a pension fund or a sovereign wealth fund, a company or an individual. Alternatively a small group of funds and institutional investors may decide to invest together (a club deal).

Where an investor in a JV is also one of the fund's investors, this is described as a co-investment. Opportunities to participate in co-investment are often offered to large investors as an incentive for them to participate in a fund.

Alternatively, investors may wish for commercial reasons to align the manager's incentives with those of the other investors by requiring the manager promoting the deal to commit some of its own capital, or the capital of certain of its key employees (typically representing 1%-5% of the total value) to the investment (manager co-commitment).

In such a case it is usually necessary to establish a vehicle, which the JV participants will hold shares in, as either a property SPV or in some cases a holding company, either directly or through a partnership. This allows the JV participants to hold proportionate shares in the economic value of a property without having to deal with the considerable legal complexities involved with joint ownership of property, as well as allowing the economic terms of

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the arrangement to be agreed contractually (via a shareholder's agreement, a partnership agreement or via the company's articles).

Vehicles established to benefit from real estate tax incentives

Many countries, including several European Member States, have established specific tax regimes and structures to encourage investment in real estate in their country or to act as a base for cross-border investment. Examples include the French OPCI and SIIC regimes.

These are highly regulated regimes with conditions designed to ensure that they can be used only for the intended purpose. Usually there is a distribution requirement such that investors are subject to tax on the income arising within the vehicle. They are not necessarily 'regulated financial undertakings' as defined in the draft directive, and in many cases the tax benefits of the regimes extend to wholly owned subsidiaries which would almost certainly not be.