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Review of the UK funds regime
HM Treasury
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Your ref: Review of UK funds regime
Our ref: 013693

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Dear Madams/Sirs

Review of the UK funds regime: A call for input – BDO response

We welcome the opportunity to respond to the call for input on the UK funds regime, published on 21 January 2021.

BDO is a leading adviser focused on entrepreneurially spirited businesses, working with clients across all sectors. This includes acting for a large range of funds and asset managers as well as businesses which have benefited from investment by all kinds of funds.

As we set out previously in our responses to the consultations on the proposed asset holding company regime, it is vital that this area is approached in a coordinated and concerted manner if this and other measures are to fully succeed in attracting funds to the UK that would otherwise be domiciled in non-UK jurisdictions (including Luxembourg, Ireland and the Channel Islands).

As further set out in our responses to the asset holding company consultations, the greatest benefit to both asset management businesses and to the Exchequer are likely to be obtained when ‘co-location’ in the UK is achieved. That is when the asset manager (and the individuals responsible for the asset management activity), the fund, and any asset holding structure are all located in the UK. This provides administrative and cost savings for the fund/management business as well as maximising the potential sources of revenue for the government. It would further boost economic activity from the professional services required to support these co-located functions.

However, given the advances made by non-UK jurisdictions (particularly Luxembourg) in becoming attractive to funds, the UK will need to go beyond being the equal of such other jurisdictions and will need to provide sufficient benefits to act as an active draw to businesses determining the location of their next fund. An absolutely key part of any amended UK funds regime will be stability and certainty.

Specific comments on questions asked in the call for input are set out below. If you have any questions on the points raised please do not hesitate to contact me.

Yours faithfully

James Pratt
Partner
For and on behalf of BDO LLP

1. Chapter 1 - Introduction

Question 1: This call for input on the UK funds regime is necessarily wide-ranging. As the government would not be able to take forward all proposals immediately, what do you think the top 3 priority proposals should be for government implementation and why?

Our top three priorities would be:

(i) Reducing the compliance and administrative burden on UK fund structures that are designed to achieve tax neutrality. This is particularly an issue for funds constituted as UK partnerships where the UK's tax and company secretarial burden far outweighs that of our main competitor jurisdictions.

(ii) The correction of overly punitive effects of certain rules in a fund context, such as the corporate loss restriction rules as they apply to the general partners of limited partnership funds (see our answer to Question 11 below for further details).

(iii) Further reliefs/exemptions that would make the UK more attractive than the established fund jurisdictions. The asset holding company regime and the fund changes discussed below are two important parts of this, but attractive reliefs and exemptions will also need to encompass the fund managers themselves. As described above, the maximum benefit to fund businesses and the Exchequer is achieved by the co-location of managers, funds and asset holding structures in the UK.

If further reforms are contemplated, the government should set out a roadmap for these so that funds have some certainty over the future direction of UK taxes for the industry.

2. Chapter 2 – The UK's approach to funds taxation

Current funds landscape

Question 2: How effective were recent reforms to UK funds taxation in achieving their aims? Please explain your answer. Could anything have made these reforms more effective, particularly in terms of increasing the attractiveness of the UK as a location to set up funds?

The reforms have been a helpful step to maintain competitiveness in certain areas. In particular, the reform of the ITC regime has helped ITCs become a viable UK-listed fund vehicle option (in terms of minimising tax costs at the UK fund level) to attract investors, compared to, for instance, a listed Channel Islands company.

However, we agree with the comments in paragraph 2.6 onwards that, in the wider context of other investment fund structures, other countries have simpler regimes from an administrative perspective. For example, a blanket tax exemption and no filing requirements for authorised investment funds is attractive when deciding where to set up a fund.

Private equity is an important part of the funds landscape in the UK (especially in the mid-market space in which our clients operate) but much of the recent focus for reform has been on authorised fund structures which tend to focus at the larger end of the market. It is important that the UK funds infrastructure caters for a wide range of funds in order to support investments and jobs across the whole sector. Our response to Question 11 below highlights some issues that need to be resolved to increase the attractiveness of the UK as a location to set up private equity funds.

Multi-asset / balanced authorised funds

Question 4: How would the proposals in paragraph 2.9 improve tax efficiency of multi-asset authorised funds? Please explain how the proposals would work in practice and how a proportionate impact on HMRC could be ensured.

The recommendations outlined in paragraph 2.9 could help minimise tax liabilities at the fund level. However, we believe that the additional administrative burden and the requirement to ascertain the tax treatment of the distributions to the investors may negate some of these tax benefits. Global fund managers may, therefore, still decide to set up in countries with a simpler tax regime.

Tax exempt fund

Question 6: Where funds are already tax neutral, how would a tax-exempt status for funds influence decisions about how and where to set up funds?

We believe tax administration is an important factor in a global fund manager's decision on where to set up a fund. Often, the preferred jurisdiction is one that has a tax regime that is easy to understand and comply with.

Question 7: How would tax-exempt funds affect the competitiveness and attractiveness of the UK funds regime? Please explain your answer providing evidence and international comparisons where possible.

In our experience, Ireland and Luxembourg have a competitive advantage,

- From a commercial aspect due to the existing fund administration infrastructure, and
- Because of the general tax-exempt status of the funds and the limited tax compliance involved to obtain tax neutrality at the fund level.

Accordingly, a tax-exempt status with limited annual tax compliance obligations would, in our view, help with the competitiveness and attractiveness of the UK for certain funds that would already achieve tax neutrality based on the current tax rules, ignoring overseas withholding tax.

We do, however, acknowledge that the tax-exempt status may affect the overseas withholding tax suffered where the UK fund cannot access the benefit of the UK's tax treaties, although we would expect that this should not be materially different to the position for European based tax-exempt funds. It is worth noting that tax-exempt funds in Ireland are able to access tax treaty benefits and Luxembourg funds can access treaty benefits in some jurisdictions.

Real estate investment trusts

Question 8: What would be the likely impact if changes were made to the REIT regime in the areas discussed in paragraph 2.16? To what extent could investment in the UK be expected to increase, and what would be the drivers for this? Could such changes be expected to impact the extent to which funds with UK and foreign property assets are managed in the UK?

The REIT regime, introduced on 1 January 2007, has successfully established itself as an attractive route for UK property investment. In order to ensure that the regime continues to remain competitive further changes to the regime are now required.

We agree that the combination of the corporate interest restriction (Part 10 TIOPA 2010) and the interest cover test in section 543 CTA 2010 makes for an unnecessarily complex calculation methodology. In such cases, we agree that only one test should be applied and recommend that the corporate interest restriction test, given its more comprehensive nature, should be used.

Gains on disposals of investment properties will generally be exempt from tax. There is, however, an exception to this, the so-called 'three-year development rule'. This applies where a property has been developed since acquisition; the cost of the development exceeds 30% of the fair value of the property (as determined by International Accounting Standards) at the later of the date the company acquired the property and the date the company joined the UK-REIT regime; and the company disposes of it within three years of completion of the development to a non-group company.

Where the three-year development rule applies, the gain on the property sale will remain subject to UK corporation tax. We consider that the rule should be amended such that:

- Where disposals are required or become necessary in order to meet statutory requirements these should be excluded from any calculation.
- The test becomes based on the highest of the following:
  - The fair value of the property immediately prior to redevelopment,
  - The fair value of the property when it joined the REIT regime,
  - The cost of acquisition.

For new entities entering into the REIT regime, the requirement to hold three properties can be an unnecessary challenge and removing this requirement would, in our view, assist in the overall attractiveness of the regime.

Currently the REIT regime does not offer any specific taxation benefits as regards the holding of overseas property. It is often the case that where REITs hold significant amounts of overseas property, local REITs are established in the overseas jurisdiction. We consider that removing the requirement to withhold tax in relation to that part of the property income distribution funded by overseas income would increase the overall attractiveness of the REIT regime.

Question 9: Are there any other reforms to the REIT regime that the government ought to consider, and why?

In certain REIT regimes globally the range of commercial activities that may be carried out is extended. For example, in the USA, Mortgage REITs are an established part of the investment landscape providing finance for commercial and residential real estate and acting as an adjunct to more conventional routes for real estate finance.

One sector that has seen significant growth over the last decade in the UK and continental Europe has been non-bank credit intermediation (or more colloquially ‘parallel banking’ or ‘shadow banking’) to provide finance to UK commercial real estate. The great majority of investment structures for this activity are sited in Luxembourg or the Republic of Ireland but advised by asset managers based in the UK.

Post-Brexit, we consider there to be a compelling case to create a framework which allows this type of commercial activity to be fully conducted from the UK, rather than from an overseas jurisdiction. In our view, an expansion of the REIT regime to allow for Mortgage REITs would provide the following benefits:

- Expansion of the commercial footprint of the UK-REIT regime in a way that draws parallels to REIT rules in other jurisdictions.
- Durability and certainty as to the prevailing tax regime.
- Better regulatory oversight of lending activities to UK borrowers.

Treaty issues

Question 10: Regarding the proposals covered in this call for input, are there any specific considerations that the government ought to take account of in the context of the UK’s double taxation treaty network? Please provide as much detail as possible.

We consider that some clarity around the availability of treaty benefits to specific funds would be helpful. Following the Anson case, there continues to be a degree of uncertainty over the tax classification of specific fund vehicles. A clearer statement of how particular entities will be treated would provide welcome certainty for investors and sponsors.

Funds constituted as UK limited partnerships (eg private equity funds) do not directly benefit from the UK’s extensive treaty network. However, the treaty network can be of use to UK resident investors in such funds, and can also be helpful where UK resident holding companies are used by such funds to make investments. This can support the UK as a holding jurisdiction for assets, which in turn can support the use of the UK for the fund vehicle itself. Therefore, considering funds and asset holding companies together is important in creating an environment that supports the UK as a fund jurisdiction.

Limited partnership funds

Question 11: What are the barriers to the use of UK-domiciled LP Funds and PFLPs, and how might tax changes help to address them? Please provide detailed proposals and explain your answers.

The call for input makes clear that the UK funds regime seeks to ensure tax neutrality for UK resident fund structures. However, there are some particular examples where this is not necessarily the case. This makes alternative jurisdictions more attractive. Two examples are discussed below.

Corporate loss relief

For a UK resident company, brought forward losses can be set off in full up to the level of the company's deduction allowance (up to £5m per accounting period). This can adversely affect a UK limited partnership fund structure (in particular large UK funds). For private equity and private equity-like funds, the corporate general partner of a fund[1] typically builds up tax losses in the fund's early years before the fund becomes profitable. When profits arise, the losses are not fully available for offset if those profits exceed the deduction allowance for that accounting period, giving rise to a cash tax liability. Given a typical management fee of 2% of commitments, all but the smallest funds will quickly be in a position where this issue could be relevant.

The general partner of a UK based fund will almost always break even over its life and so have no net profits over this period. The tax liability referred to only arises because of the timing of the profits and that interaction with the corporate loss relief rules. It is unclear for many funds how such a liability would be funded. General partner entities are typically set up anew for each fund and so would only derive their resources from their profit share/management fee from the fund. If fund managers end up with a real possibility of needing to fund such a liability then this will act as a disincentive to setting up a UK fund.

We would propose an exemption from the corporate loss restriction rules for the general partners (or members of general partners) of a limited partnership that is a collective investment scheme. We are aware that this issue has been discussed extensively with the BVCA and so it will be familiar to HM Treasury and HMRC. We see this issue frequently affecting our clients' decisions regarding which jurisdiction to establish their funds in.

Carried interest holders

Carried interest holders can also be adversely treated where they are UK resident. Following a number of changes in the taxation of carried interest returns since 2015 (including disguised investment management fees, non-UK domiciled carried interest holders and income based carried interest changes), the UK has become a less attractive location for the fund managers themselves. This is particularly true for firms where there is uncertainty at the outset as to how long investments will be held.

The income based carried interest rules do have some helpful provisions for certain asset classes (for example, where significant interests are held), but a more general private equity exemption would make the UK more attractive again. The computations to track income based carried interest can be complex and so add a further burden to private equity managers whose strategies are not the target of these rules.

[1] Either a corporate general partner or corporate member of a partnership or LLP general partner

Further barriers

We believe the compliance burden for funds constituted in the UK as limited partnerships is a disincentive to locate funds in the UK. In the UK all partnerships need to file an annual return and accounts, with audited accounts required depending on the circumstances. Although this is not a material barrier for the firm itself, we do have a large number of clients who locate their funds elsewhere because particular investors express a preference for a jurisdiction where their personal details are not publically available. For example, there is no annual return required in Jersey and so investors in a particular fund have their privacy protected. We would propose allowing firms to redact the publicised version of their annual returns.

As well as the Companies House administration, there is also the HM Revenue & Customs compliance burden. The filing requirements for a UK partnership return were recently made more onerous by requiring firms to file partnership returns on four different bases: UK income tax basis, UK corporation tax basis, non-UK resident income tax basis and non-UK resident corporation tax basis. We would propose clarifying the guidance so that only relevant bases need to be considered (eg no corporation tax basis should be required where there are no UK resident corporate partners). Furthermore, the detailed schedules for non-resident investors and the unique taxpayer references they use for the purposes of the tax return, as well as those required for partnerships that are partners in other partnerships, have made an investment fund’s partnership return very burdensome. This is very uncompetitive with other jurisdictions, which focus their requirements on filing for resident investors rather than resident fund vehicles.

Finally, as has been well documented, following Brexit there can be a general preference for EU investors to invest in EU member jurisdictions. This is mostly driven by regulation. Therefore, the UK’s funds regime will need to be made sufficiently attractive to reverse this preference.

3. Chapter 3 – The UK’s approach to funds regulation

We have no specific comments on the questions asked in Chapter 3. We would, however, note as above that it is essential for all facets of the UK funds regulatory and tax environment to be attractive to managers in order to achieve success.

4. Chapter 4 – Opportunities for wider reform

Defining areas of opportunity

Question 19: Do you agree that reforms to enhance the attractiveness of the UK funds regime should focus on appealing to the creation of entirely new funds that have not yet been set up?

The call for input rightly acknowledges that funds and their investors already have their preferred jurisdictions through which to invest. We think there are a number of barriers to using the UK as the fund jurisdiction (see for example our response to Question 11), but removing these barriers would merely put the UK on the same/similar standing as Luxembourg, Ireland, the Channel Islands etc. To attract funds (and their managers and, where relevant, their asset holding structures) to the UK, we believe that further reliefs/exemptions are needed to make the UK a more attractive jurisdiction than other established jurisdictions - particularly in light of Brexit.

Question 20: Why do firms choose to locate their funds in other jurisdictions in cases where the UK funds regime has a comparable offering, for example ETFs? Are there steps which could help to address this following the potential reforms to the UK funds regime discussed in this call for input, and would the scope to address this vary depending on the type of fund or target investor market?

As mentioned in our responses to Questions 7 and 11, one of the barriers we commonly see in relation to investment funds is the level of tax compliance and administration required in the UK to achieve the comparable tax neutral position of funds located in other European countries. Any steps that ease the compliance burden for funds would be viewed as a positive.

Our response to Question 11 sets out further issues that firms have with using the UK for their fund structures. These barriers also often drive firms to locate their funds in alternative jurisdictions that do not have such barriers, for example, Luxembourg or Jersey/Guernsey.

Enhancing existing fund structures - ITCs

Question 24: Are there specific barriers to the use of ITCs, either from the perspective of firms creating fund products or from the perspective of investors seeking to access them? Are there specific steps which could address these?

As noted in paragraph 2.3, ITCs are becoming increasingly common fund vehicles for renewable funds that also use intermediate SPVs in the structure. While this may not always be a specific barrier, it is noted that these SPVs are subject to the normal UK corporation tax rules and, therefore, potential tax costs could arise 'lower down' the structure. To resolve this, it would be helpful for the ITC-specific tax rules to be extended to the intermediate SPVs, in a similar fashion to the operation of the UK REIT regime. We note that the proposals in the asset holding company regime may help reduce the tax burden in this regard.

New fund structures – long-term asset fund

Question 28: Do you foresee any issues with the LTAF adopting the current tax rules for authorised investment funds? Would the nature of an LTAF's investments, and the tax treatment of the income it receives in respect of those investments, mean that the current rules for authorised funds lead to tax inefficient outcomes?

Broadly the authorised investment fund tax rules should achieve the tax objectives for a LTAF. One potential scenario that may cause a tax inefficient outcome (double taxation) is if the LTAF invests in a tax transparent venture capital/private equity structure which has an underlying element of trading but for accounts/regulatory purposes is still treated as capital. This may require the white list of transactions to be revisited in the context of a LTAF.

Question 29: Are there any other tax considerations, outside of those that follow from the adoption of the current tax rules for authorised funds, that will be important to the success of the LTAF? Please explain your answer.

The tax regime for LTAFs should be sufficiently flexible to allow them to operate commercially and to realise cash in the event of a redemption request from investors without suffering tax that would not have otherwise been incurred. Where the realisation event is via a sale of assets, the general capital gains exemption in the authorised investment fund tax regime should facilitate this but further analysis may be necessary to confirm the current tax rules can achieve the desired outcome.

New unauthorised fund vehicles

The existing vehicles are well understood by investors. Consequently, we believe effort would generally be better spent on improving those vehicles currently available. Our view on some of those improvements is set out above.