BPF Response to HM Treasury’s Consultation on Reforms to Substantial Shareholdings Exemption

To: SSEConsultation@hmtreasury.gsi.gov.uk

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Introduction

The BPF represents the commercial real estate (CRE) sector – an industry with a market value of £1,662bn, which contributed more than £94bn to the economy in 2014. We promote the interests of those with a stake in the UK built environment, and our membership comprises a broad range of owners, managers and developers of real estate as well as those who support them. Their investments help drive the UK’s economic success, provide essential infrastructure, and create great places where people can live, work and relax.

The UK’s commercial real estate sector contributes about 5.4% of GDP, and directly employs 2.1 million people, or 6.8% of the labour force. It provides the nation’s built environment and is spreading out from its core investment in the nation’s offices, shops, leisure facilities and factories, to support the new economy through investments in logistics, healthcare, student accommodation, infrastructure and housing, including through Build-to-Rent investment in new housing.

The sector is one of the most successful in the world at attracting domestic and overseas long-term investment capital into the renewal of the UK’s towns and cities. Such large, long-term, patient investors are critical to the urban redevelopment and regeneration of our country, which the vote on Brexit has illustrated, is so important if we are to feel we are all part of one nation. Such investors include pension funds, sovereign wealth funds and other sovereign investors, insurance companies, property groups, REITs and private equity real estate funds (PERE).

For such investors, investment in UK CRE can form a significant part of their real estate investment strategy, but equally they will look to manage risk through diversification across jurisdictions. Similarly, many of the UK’s larger property groups are international in outlook, investing in CRE outside the UK, particularly within other EU member states, although they may also invest further afield.

Although the Consultation on Reform of the Substantial Shareholdings Exemption (the Consultation) was announced and launched pre-Brexit in different economic and political circumstances, we consider that it is now even more important that the government seizes the opportunity to carry out a fundamental reform of SSE. Following the recent EU referendum, the attractiveness of investing in the UK should be enhanced wherever possible. The UK needs more than ever to show that it remains outward looking and is indeed “open for business” globally. A comprehensive exemption for gains on share disposals, particularly when coupled with other recent reforms to the UK corporation tax system, would help deliver that message.

Providing business with an exemption for gains on share disposals through an extended SSE would not, in our opinion, run counter to the UK’s commitment to tackling international tax avoidance by companies. Through its work at the OECD and the EU (most recently in supporting early implementation of the anti-avoidance tax directive), the diverted profits tax and the current proposed changes to the UK’s rules on the tax deductibility of interest, hybrid mismatches and transfer pricing, the government has shown a willingness to ensure that companies cannot arbitrage differences in jurisdictions’ tax systems for a tax benefit. In a more domestic
context, it has brought in the ATED regime to counter certain types of enveloping of assets and is ensuring offshore developers of UK property can no longer avoid paying UK tax on their profits.

But at the same time as cracking down on such corporate behaviours, it is equally important that government recognises within the tax system the valuable contribution of business to the UK economy through investment. Extending SSE would do this: encouraging investment through reducing tax distortions, such as potentially paying tax twice on the same profits on selling a (taxable) business and, importantly, enhancing the UK’s international competitiveness - particularly as many EU member states, including France and Germany, already have capital gains exemptions for sales of shareholdings.

We therefore welcome the opportunity to respond to this Consultation.

We set out below our key recommendations. Detailed responses to Consultation are set out at Appendix 1 and we include further supporting information in appendices as follows:

Appendix 2: Diagram of (example) Property Group structure
Appendix 3: Summary of participation exemption regimes in Netherlands. Luxembourg and Ireland
Appendix 4: A Targeted SSE for funds: comments

Key recommendations

1. **Be ambitious!**

   As a result of the change in the UK’s circumstances since the Consultation, the government should be ambitious in its plans for reform the SSE. The UK should consider adopting a participation-exemption style SSE. If the UK wants to attract holding companies, then it has to offer a comparable regime to those that already exist in other jurisdictions if it is to persuade businesses of the merits of the “new”, as opposed to the comfort of the “familiar and known”.

2. **Keep it simple**

   If the government decides to proceed with a substantive reform of the SSE, it is important that any new relief is simple, certain and easy to apply. This refers as much to the terms any anti-avoidance provisions included within the rules as to the conditions attached to the relief itself.

   The importance of simplicity cannot be underestimated. Within the EU, there are a number of well-known holding company jurisdictions. Their participation exemptions are relatively straightforward. They are familiar to businesses, in part due to successful marketing of their benefits by advisers within those jurisdictions over many years. If the UK wants to attract such holding companies - and, with them, jobs and associated professional services - then it has to offer a comparable regime - both in terms of scope and simplicity. This is essential if the UK is to be able to persuade businesses of the merits of the coming to the UK.

3. **Be comprehensive - and include CRE**

   The original drivers for SSE were to improve businesses’ international competitiveness and to limit the circumstances in which tax could distort commercial decision-making. Its purpose was to support productive business. These drivers - and indeed those drivers listed in Chapter 3 of the Consultation - apply
as much to CRE as any other business. CRE businesses deliver significant economic benefits, jobs and growth within the UK, both in their own right but also in the support they afford to other businesses through providing high-quality flexible accommodation.

Accordingly, if the SSE is to be extended, CRE businesses should be brought within its scope. Extending to real estate groups the advantages that SSE has to date provided to trading groups would improve their competitiveness and therefore the value they are able to add to the UK economy. Furthermore, given the UK’s incredibly deep pool of property management expertise, extending the SSE to include CRE businesses would be of benefit in attracting international investors’ property holding structures into the UK – creating employment opportunities, and increasing demand for related professional services.

Finally, there are strong competitiveness drivers for extending SSE to include CRE. In each of the Netherlands and Luxembourg, the participation exemption applies equally to CRE-owning companies as it does to trading entities. We see no policy reason why the UK should be different in this regard in offering an investment holding regime already widely available in other OECD countries.

We would welcome the opportunity to discuss any aspect of our response in more detail. Please get in touch if you require any further information.

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Appendix 1: Responses to Consultation Questions

Question 1: To what extent does the SSE currently meet its objectives of:

(i) encouraging rational decision making on restructuring and the disposal of trading entities within a group, and

(ii) reducing incentives to adopt complex offshore holding company structures?

1. Many CRE businesses carry out significant property rental activity. As a result, SSE is not available on disposals of subsidiaries because such groups do not carry on “to a substantial extent” trading activities. The CRE sector therefore has relatively limited practical experience of the impact of SSE on decision making.

2. Accordingly, UK based CRE businesses have learned to factor corporation tax on chargeable gains (CGT) considerations in their business planning - and thus into their investment structures.

3. CRE businesses build in as much flexibility as possible in to their investment holding structures so that they can choose whether to dispose of investments by way of a share sale or an asset sale. This is one of the reasons that non-UK CRE investors generally hold UK property through overseas entities.

4. Similarly, this desire for flexibility leads to many CRE businesses to set up an offshore holding platform, commonly in the Netherlands or Luxembourg. This can include UK-based property groups - although for them an offshore platform would mainly be used for non-UK investments.

5. These platforms are generally straightforward - a simple holding company above a number of property owning companies. The use of such a platform has commercial benefits: it allows groups to “pool” their non-UK investments, and related administration and compliance, creating (in practical terms) a ring-fence between UK and non-UK operations.

6. In general, the property owning companies will be established (and fully taxable) in the same jurisdiction as the properties they own - see Appendix 2 for a diagram of a typical holding structure. The typical CRE holding structure is therefore not dissimilar to the fund structure set out in Chapter 5 of the Consultation, and similar considerations apply when selecting a suitable holding company jurisdiction.

7. Both the Netherlands and Luxembourg offer a participation exemption. See Appendix 3 for a summary of these two countries’ participation exemption regimes. As can be seen, the rules governing the participation exemption in these two jurisdictions are clear and easy to comply with.

8. That said, establishing and running an offshore holding structure entails a certain level of cost (both in relation to time and expense). These costs include fees of local lawyers, accountants and similar service providers, directors’ fees, and staff costs. Given the significant amount of property expertise is in the UK, senior (UK-based) employees will need to travel out regularly, resulting in significant travel costs as well as the inconvenience (and opportunity cost) of travelling. This all affects investment returns and ultimately the amount of capital that can be invested in towns and cities.

9. In addition, those costs are likely to increase in the short to medium term following on from the OECD BEPS project (as the government itself highlights in paragraph 3.16 of the Consultation). Absent a valid
alternative, groups will be revisiting the operation of their offshore platforms: for some, this may involve building up their current offshore presence, both operationally and in terms of management expertise. In particular, it may lead to existing UK-based employees needing to relocate, whether through secondment or more permanently, as part of any post BEPS re-alignment of functions.

10. Plus, these costs are not just costs to business. They also represent an opportunity cost for the Exchequer in the context of being potential revenues foregone. In 2007, the Investment Management Association asked KPMG to carry out research on the value contributed to the UK economy by UK domiciled funds. Although these figures are now somewhat out of date, they still serve as a useful illustration. KPMG estimated that for every £1 billion of funds which were in an offshore location rather than the UK, the cost to the Exchequer was £0.7 million in terms of lost direct tax revenues, and then extrapolated these figures, concluding that, if the UK were home to those funds domiciled in Luxembourg and Ireland with a UK investment manager, additional UK direct tax receipts could be equivalent to £286 million a year.

11. As mentioned above, the reason for having an offshore holding platform is maximising flexibility. The benefits of an offshore platform will generally only be realised if the CRE investor disposes of an investment by way of a share sale. This is because, if the buyer prefers to buy the property directly (which is the case for many CRE investors), the (ex) property owner is very likely to repatriate the sale proceeds by dividend to its parent holding company. Although the participation exemptions within countries such as The Netherlands and Luxembourg confer exemption from tax on dividends received from qualifying subsidiaries, the same position would follow had that property owner been owned directly from the UK under the UK’s.

12. If the UK were to introduce a form of participation exemption that CRE businesses could benefit from, the rationale for having an offshore holding platform would be less clear-cut. Extending the SSE in this way could therefore incentivise groups within the CRE sector to onshore their holding platforms. This would have the benefit of increasing the resources deployed in the UK, as well as potentially improving efficiency: by being able to focus expertise in one jurisdiction - the UK - management of the business would be simpler administratively.

13. Plus, in addition to facilitating outward investment by UK CRE businesses, an extension to SSE would enhance the attractiveness of the UK to offshore property investors (including those with limited or no UK property assets and so no obvious nexus to the UK) in a post-BEPS world.

**Question 2: What complexities arise in practice for domestic or foreign headed groups in applying the SSE?**

**Non-related overseas activities**

10. As the SSE tests apply to the overall group, issues can arise where a UK trading group is part of an international group. Activities carried out overseas may not fit easily into UK tax categories. Plus, given that a significant amount of information will need to be gleaned from accounts, differences in accounting standards across jurisdictions can compound this problem. This makes it difficult to assess whether non-UK business activities are “trading” or not.

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1. This research is referenced in a memorandum submitted to the Treasury Select Committee in June 2008: see http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/355/355we24.htm
2. I.e. if Option 1 or Option 3 were adopted.
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11. Within an international group, the UK is only likely to represent only a small proportion of overall activities. As a result, uncertainties about the overseas business can mean that a purely UK deal, where the overseas activities are irrelevant, falls outside SSE, even where the sale is by a UK holding company, and UK activities meet the trading test. See also our response to question 10.

12. In such circumstances, the taxpayer has the option of seeking clearance from HMRC. But where there is genuine uncertainty - because of the novelty of the facts - there is no guarantee that HMRC clearance will be given, particularly if the facts are relatively unusual.

13. A specific example concerns the status of a complex retirement housing business. For local (non-UK) tax purposes it was considered an active business, but the accounts showed the homes owned by the group as investment properties. At the relevant time, there was no comparable UK business model. The novelty of this situation meant it was not possible to conclude with certainty that SSE was applicable. This had an impact on the commercial negotiations given the seller needed to factor CGT into its decisions.

Reorganisations

14. SSE can lead to complications when carrying out a group reorganisation given the interaction between the CGT reorganisation provisions and the SSE rules.

15. For example, the technical analysis on an intra-group reorganisation appears unnecessarily complicated in terms of how the conclusion is reached, rather than the conclusion itself: see CG53170A of HMRC Capital Gains Tax Manual as originally published in 2002.

16. This also applies to considering the technical application of SSE to a disposal following an earlier intra-group reorganisation, particularly in relation to confirming that shares have been owned for the minimum holding period.

17. Please see also our response to question 18.

Question 3: In what additional situations do you consider the SSE should be available for substantial share disposals and how does this compare to the availability of equivalent exemptions in overseas jurisdictions?

General comments

14. As a minimum, SSE should be available on the disposal of a trading company, without regard to the overall status for tax purposes of the group of which it is a member. We are therefore supportive of Option 2 (see our comments in “SSE to apply to all trading companies” below).\(^3\)

15. However, we are strongly of the view that any reform of SSE should not be restricted to Option 2.

16. In particular, we firmly believe that the government should seize this opportunity to effect a wider reform of SSE - expanding its scope and moving towards a broader “participation exemption” style relief. We agree with the CBI that, following the recent referendum in respect of the UK’s continuing membership of the EU, the attractiveness of investing in the UK should be enhanced wherever possible. The UK needs to

\(^3\) We also note this particular reform was first raised as part of the various consultations on modernising corporation tax (2003 - 2005). Such an extension of SSE (to non-trading companies at investee level) was supported by 11 out of 14 respondents to the Technical Note: Corporation Tax Reform (December 2004) and the government indicated it would keep this under review. Such a reform is arguably overdue.
show that it is indeed “open for business” globally. A comprehensive exemption for gains on share disposals, particularly when coupled with other recent reforms to the UK corporation tax system⁴, would help deliver that message.

17. In this context we are generally neutral between Option 1 and Option 3 in policy terms. We note however that an approach based on Option 1 would have the benefit of making the UK SSE regime more directly comparable to the type of participation exemption offered by certain EU states, which would assist the UK in terms of its competitiveness against such long-established holding company jurisdictions. See our comments in “SSE as basis for participation exemption?” below.

18. Option 4 seems to provide little by way of additional benefits - and risks creating further complexity within the rules because of the need to address the issues highlighted in paragraph 4.27 of the Consultation.

19. Finally, we recommend that the SSE is simplified regardless of the scope of any reform. The CBI, in its response to this Consultation, highlights the difficulties businesses face in assessing whether or not the SSE applies to a disposal (and see our response to questions 2 and 18).

20. A “simplification review” of SSE would be consistent with the government's general tax simplification agenda, as well as being helpful to business. A simpler and more certain SEE would benefit business by reducing frictional costs associated with disposals under the existing rules.

**SSE to apply to all trading companies**

21. When SSE was originally introduced in 2002, government policy was that the relief should only be available to trading companies. The government stated that:

> “The proposal is to include within the scope of the relief shareholdings in companies that carry on a property-based trade, such as property dealing or providing property management services. However, holding property by way of investment, such as holding to let, would not amount to carrying on a trade for the purposes of qualifying as a trading company.” ⁵

18. However, the conditions attaching to SSE mean that relief is not available on disposals of shares in trading companies where those trading companies are held within a “mixed” group. This can be the case even where the majority of a group’s activities are trading in nature, given that HMRC practice is to require a minimum of 80% trading activity for relief under SSE to be available.

19. We consider that, as a minimum, the SSE should be available to all disposals of a “substantial shareholding” in a trading company, regardless of the overall status of the group of which it is a member. We consider that this is in keeping with the policy that led to the introduction of the relief: i.e. that any gain on shares in a trading subsidiary basically represents after tax profits. As a result, the characterisation for tax purposes of (retained) members of the group should be irrelevant.

20. In terms of other jurisdictions’ participation exemptions, only Ireland restricts eligibility to trading subsidiaries. This in itself would suggest that, to be competitive, the UK should look to extend SSE beyond trading activities.

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⁵ See paragraph 3.5 of the Inland Revenue Technical Note “Corporation Tax: Chargeable Gains: Deferral Relief for Substantial Shareholdings” (23 June 2000).
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**SSE as basis for participation exemption?**

21. Our view is that SSE should be adapted to provide a broader exemption from CGT on disposals of subsidiaries more generally.

22. Moving to a broader exemption would require some or all of the existing conditions to be relaxed. We consider that such a change, coupled with the recent changes to the taxation of dividends (in 2012) and the reform the CFC rules (in 2009) will make the UK more attractive as a global holding company jurisdiction. In addition, it may encourage UK groups who currently hold non-UK subsidiaries through offshore holding platforms to relocate those platforms to the UK.

23. If the UK does extend its SSE in this way, it is important that any conditions attached to the relief are as clear and certain as possible. Any new regime must be simple and easy to apply. This is the case whether Option 1 or Option 3 is adopted. If Option 1 applies, the need for simplicity and clarity applies as much to the terms of the exemption as to any anti-avoidance provisions included as part of the rules.

24. The importance of simplicity cannot be underestimated. Within the EU, there are a number of well-known holding company jurisdictions. Their participation exemptions are relatively straightforward. They are familiar to businesses, in part due to successful marketing of their benefits by advisers within those jurisdictions over many years.

25. If the UK wants to attract holding companies, then it has to offer a comparable regime to be able to be able to persuade business of the merits of the “new”, as opposed to the “familiar and known”. This is particularly the case given the result of the EU Referendum, and the resultant uncertainty as to the UK’s continuing relationship with the EU.

26. Please see Appendix 3 which contains a summary of key features of the participation exemption regimes in each of Netherlands, Luxembourg and France and see also our response to question 8.

**Question 4: To what extent could reform of the SSE impact on the likelihood of groups locating holding companies in the UK, and what are the potential benefits from an economic and fiscal perspective?**

27. In the context of the CRE industry, there are three specific benefits that could arise from a substantive reform of the SSE (as proposed under Option 1 or Option 3):

   (a) UK property groups locating holding platforms for non-UK property businesses in the UK:

   (b) encouraging re-investment in development activities, by removing tax barriers to part disposals of real estate investments; and

   (c) creating a level playing field between different categories of investors.

   Commenting on each in turn:

   **UK property groups and holding platforms**

28. As noted in our response to question 1, the investment structures of UK CRE businesses reflect a desire to maximise their flexibility when it comes to disposing of investments. This can include maintaining an offshore holding platform that facilitates disposing of investments by way of share sales.
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29. Whether a disposal is by share sale or asset sale will depend on negotiations between the parties, but it is worth noting that many real estate investors prefer to buy property assets directly. In this way the investor avoids any acquiring the history - and potential liabilities - of a company. Given that the question of asset vs. shares on a sale is dependent on the buyer’s preferences as much as the seller’s, we would not anticipate this changing simply because of an extension to SSE.

30. If the UK extended SSE to apply to CRE businesses, the need for an offshore holding platform to achieve that flexibility should disappear. For UK CRE businesses, there would be clear benefits in locating their holding platform within the UK. Operationally, there would be advantages in having the head office team responsible for the running of the holding structure - there would be no need to pay fees to third parties Plus, onshoring such activities is likely to result in an increase in demand for both jobs and support from UK based professional service providers. There could also be significant cost savings, increasing the amount of resources available to be invested by the business: anecdotally, we understand that it can cost up to €100,000 per annum to operate a single offshore holding company⁶ – which, assuming assets under management of say €1bn to £3bn, could mean annual running costs for an offshore platform of between €500,000 and €1,000,000.

31. Ultimately, however, a CRE business’ investment structure will be determined by a range of commercial and regulatory factors. A group would need to take these into account in any decision to move its offshore holding platform to the UK. For instance, the uncertainty caused by the result of the EU referendum may mean that, for the time being, many CRE businesses do not feel there is enough clarity regarding the relationship between the UK and other EU countries (including the status of EU Parent/Subsidiary Directive or (in relation to those CRE businesses structured as funds) the AIFM Directive to warrant a decision to set up a UK holding platform.

Encouraging re-investment

32. Developing and holding real estate is a very capital intensive business that requires ‘locking up’ significant amounts of capital for extended periods of time. This potentially gives rise to investment concentration risks, which CRE businesses often mitigate by entering into partnership or joint venture (JV) arrangements with other investors.

33. In a development context this often happens at the start of the project (i.e. both parties share exposure to the construction risk), but could equally happen at a later stage in the development project - potentially some time after completion. If the developer/owner then sells part of its stake to an outside investor, it can use the consideration to fund other projects. In effect, entering into such arrangements to release capital may be necessary to prevent business stagnating.⁷

34. Where this takes place, the developer will often be considered an investment business for tax purposes (they developed to hold, rather than to sell), which means that SSE will generally not be available. A potentially significant capital gain might therefore arise. The tax on such gain is likely to be material, and may affect a group’s willingness to sell, absent any available reliefs (whether capital losses in the group or non-trading deficits).⁷ Extending SSE so it applied to such disposals would therefore remove a tax barrier to decision making by such groups, and allow the release of capital for further investment.

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⁶ Again, we note that the level is likely to increase as a consequence of the OECD BEPs measures, given the need for closer alignment between holding structure and management activities as noted in paragraphs 3.14 to 3.17 of the Consultation.

⁷ Note that the ability to use carry forward non-trading deficits to shelter gains will be restricted post 1 April 2017 under the announced corporation tax loss reforms.
There is also an argument for extending SSE in this case based on neutrality.

The activities of such developer/owners are classified as “investment” for tax purposes; that of a developer/seller as “trading”. This distinction arises because of the revenue/capital division that underlies the UK tax system. However, the underlying development activity is the same: the difference links to how the developer takes it profits – whether, instantly, through an immediate sale or from future income by renting. In both cases, those profits are taxed as they accrue. Both types of developer contribute to the local economy, providing the properties themselves, but also related infrastructure, but the developer/owner will continue to contribute to the local economy over the long-term (after all, it needs the local economy to flourish for its business to perform well).

Given these similarities, it seems difficult to justify a distinction in tax treatment on sale of an interest in the developer.

Creating a level playing field

CRE businesses can take on many forms. For example, within the European CRE market, REITs, corporate property groups, developers, pension funds, sovereign wealth funds and other sovereign immune investors, insurance companies and funds frequently compete for investment opportunities. Just looking at the UK CRE market as an example: a recent IPF Research Paper identified that UK institutional investors (insurance companies and pension funds represent around 17% by value of UK commercial property investment; with UK REITs and listed property groups representing a further 15% and overseas investors (excluding Channel Island domiciled collective investment schemes) 28%.

These different types of investor have varying tax attributes. A UK REIT will benefit from exemption from CGT on asset sales, but not on share sales (whether or not the company being sold is part of the exempt or residual business). A UK property group will be fully taxable on both asset and share sales. A property developer could be subject to corporation tax on trading profits (on asset sales) and (if UK based) may be able to benefit from SSE on qualifying share sales. UK pension funds will be exempt from CGT, as will be non-resident investors such as overseas pension funds and sovereign investors who will generally be using offshore holding platforms of the type the Consultation describes in Chapter 5.

With returns measured on an after-tax basis, when bidding for particular opportunities, those CRE businesses that are able to (in effect) discount tax on disposals can price more competitively than those who are subject to CGT on any exit. We appreciate that this is a function of how the market operates – not all investors are taxed in the same way.

Therefore, although we support, and can see the merits of, crafting a targeted SSE in relation to funds, we consider that a comprehensive SSE, capable of applying to all CRE businesses, would be preferable as it would help level the playing field for those UK CRE businesses competing internationally for investment opportunities, resulting in a fairer outcome for UK business. In particular, it would mean that such businesses do not need to “incur the trouble and expense of setting up an overseas holding company” in order to be able to compete successfully in the marketplace.

9 See paragraph 1.7 of the June 2000 Technical Note on relief for substantial shareholdings.
On the other hand, conferring an advantage on funds (and as a result on certain categories of non-resident investor only) could mean that more UK businesses decide that they need to establish an offshore holding platform for non-UK activities just to remain competitive.

Question 5: To what extent do you agree with the parameters set out for a comprehensive exemption?

We agree with the parameters that:

(a) SSE should not be available for share disposals in the ordinary trading course of a business.

We agree that the minimum shareholding requirement helps to achieve this result. However, in relation to the 12 month minimum holding period, we agree with the CBI that this is not relevant in this context. SSE is a relief from capital gains tax. This means a shareholding must be held for investment, not trading purposes. A disposal in the ordinary trading course of a business should be a disposal on trading account and so outside CGT (and the SSE) in any event; and

(b) there should be symmetry between capital gains and losses.

The other listed parameters link to the concerns raised in the Consultation relating to possible avoidance through either tax motivated incorporation (specifically individuals putting personal portfolios in a corporate wrapper) or groups claiming SSE on “passive” assets.

We do not consider that real estate should be seen as a “passive asset” in this context. The Consultation emphasises the importance of the exemption being confined to gains that result from effectively taxed income. Income from real estate is effectively taxed: countries typically exercise taxing rights on real estate income in the country where the asset is located (as recognised by Article 6 of the OECD Model Tax Convention). Expected yield (i.e. rental earning potential) is a key factor in property valuation, meaning that capital values tend to be highly influenced by expected future income: income which should be taxable as it arises. See also our response to question 11.

That said, we acknowledge and appreciate the government’s concerns as to possible misuse of an extended SSE. They reflect the concerns that were highlighted in the initial consultations on SSE in 2000, particularly relating to money-box companies. However, we consider that such concerns should be addressed by targeted anti-avoidance rules, rather than being incorporated as a general eligibility conditions within the exemption itself. See our response to question 7.

If the UK adopts Option 1, it will be offering a regime that is intended to compete directly with that offered by other EU jurisdictions. We therefore consider that the government should take account of how other jurisdictions have dealt with such concern. In recent years, the Netherlands amended its rules, introducing various anti-avoidance provisions which we understand are directed at addressing some of the concerns the government has identified in the Consultation. These include a “subject to tax” condition and a requirement that, in order to qualify for exemption, a subsidiary must not have a majority of “portfolio low taxed assets”– defined (in broad terms) as passive assets, the income of which is subject to an effective tax rate of less than 10 per cent.10

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10 Note: The Netherlands participation exemption is clear that real estate is not a passive asset.
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48. See Appendix 3 which summarises the conditions applied in the Netherlands.

Question 6: To what extent do you consider that a comprehensive exemption for gains on substantial share disposals, that imposes fewer conditions on the nature of the companies involved in the transaction, could address the concerns raised in the previous chapter?

49. A comprehensive exemption, that was simple and clear in its terms, and imposed fewer conditions on the nature of the companies involved, would go a long way to meeting the concerns raised in relation to Chapter 3.

50. However, we note the success of the UK as a holding company jurisdiction is dependent on a number of factors, not just a reformed SSE. Over recent years, changes to the UK tax regime have made it much more attractive for holding companies. The UK also benefits from an extensive treaty network, which makes it a good location for international businesses.

51. The recent uncertainty post the EU referendum may (in the short term at least) have an impact on inward investment. However, as issues relating to the UK’s relationship with the EU resolve during negotiations, that uncertainty will fade. The UK needs to take steps to enhance its attractiveness now to offset perceived downsides from the referendum result. It needs to evidence its continued global outlook and readiness to compete (as an independent nation) for international investment.

52. In addition, as set out in our response to question 3, that global outlook not only involves welcoming inward investment, but also facilitating outward investment by UK businesses, including CRE, in each case, contributing to UK economic growth.

Question 7: To what extent could the avoidance risks, including enveloping risks, inherent in a comprehensive exemption be dealt with through anti-abuse provisions?

53. Any anti-abuse provisions must be simple, clear and targeted.

54. If the quid pro quo of a comprehensive exemption is pages of complex anti-abuse provisions, the UK’s attractiveness as a holding company is very likely to be reduced. Businesses would need to be confident that they were not inadvertently caught by any anti-abuse rules – and if those are more onerous than in other participation exemptions, the UK’s competitiveness would be damaged as businesses would not want the time and expense of identifying if they are eligible for SSE if it could be avoided (by locating elsewhere).

55. The Consultation raises three specific avoidance concerns:

(a) creating incentives for individuals to hold their assets through a corporate vehicle in order to defer tax on disposal gains until they are distributed as a dividend or the company is liquidated (effectively tax-motivated incorporation or money-boxing);

(a) companies avoiding corporation tax on gains relating to the disposal of property, and intellectual property used in their business by holding and then disposing of these assets through corporate vehicle (which the Consultation refers to as “enveloping passive assets”);
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(b) the risk of repatriation of profits from portfolio investments held in low-tax jurisdictions tax free through a capital gains disposal, putting additional pressure on the CFC rules.

56. As a general comment, the concerns identified by the government are not unique to the UK. Similar concerns arise in other jurisdictions that provide a participation exemption. In particular, the Netherlands changed the rules attaching to its participation exemption to address these risks (see Appendix 3). The types of limitation introduced by the Netherlands may therefore represent appropriate safeguards for the Exchequer.

57. Then, SSE contains a targeted anti-avoidance provision in paragraph 5, Schedule 7AC Taxation of Chargeable Gains Act 1992, which applies in certain circumstances where there is an “untaxed gain” (defined to be profits not brought into charge to tax).

58. Finally, in 2013, the government introduced a general anti-avoidance rule (or GAAR). The GAAR was introduced to counter abusive tax arrangements. In working out whether an arrangement is abusive, account must be taken of the policy objectives of the relevant provisions. Evidence of policy objectives can be taken from parliamentary papers and the GAAR guidance.

59. The GAAR therefore offers a protection against the risk of avoidance which was not available when SSE was originally enacted. This means that the government could, through the use of appropriately detailed examples, supplement any purposive anti-avoidance provision to illustrate the types of disposal that are not intended to benefit from the SSE. This would not only serve as a “warning” to taxpayers, but could be used by HMRC to challenge a taxpayer’s use of SSE.

60. In addition, we set out below some observations on the specific concerns raised in the Consultation.

Enveloping passive assets
61. When the REIT rules were introduced, similar concerns arose in relation to trading groups “enveloping” land to get the benefits of REIT tax exemptions.

62. The REIT legislation therefore included specific provisions to counter this risk. Section 604 Corporation Tax Act 2010 excludes a letting business that is “owner-occupied” (determined under generally accepted accounting purposes) from the scope of the REIT rules.

63. A similar approach could be taken to protect against this risk for the purposes of SSE.

64. We assume that such an approach would also be feasible in relation to intellectual property used within a group (for example, excluding a business that holds such property as a passive assets and licences those rights (primarily) within a group. In this context, we understand that the patent box rules contain specific provisions to determine “active ownership” of intellectual property.

Tax-motivated incorporation
65. The concerns raised here relate to individuals taking advantage of SSE to (in effect) convert income into (tax-free) capital.

66. First, the UK tax rules already contain a number of provisions intended to counter “income to capital” and “deferral” schemes, which may be applicable to specific fact-patterns.
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67. Secondly, the concern here is an individual incorporating its business because of a perceived benefit under SSE, rather than the sale itself (although the tax benefit is achieved because of the sale, it only exists because of the incorporation). Although it is clearly not appropriate to prevent a person incorporating a business, if the incorporation involves a transfer of capital assets, it is likely that a taxpayer will seek incorporation relief under section 162 Taxation of Chargeable Gains Act 1992.

68. Although this relief currently applies automatically (a taxpayer only notifies HMRC if electing out), given the benefits that could follow from incorporation (under SSE or otherwise), we would query whether this approach could be revisited? However, we appreciate that a change to the incorporation relief provisions may be administratively difficult (and raise resourcing implications for HMRC).

69. Thirdly, the Consultation refers to an individual using a corporate structure to defer tax on gains (until proceeds are repatriated by dividend or there is a liquidation).

70. This suggests that the concern arises where individual A incorporates Company X as a holding company. Company X owns Company Y, which carries on a business/holds assets. A deferral strategy would involve Company X selling Company Y, and then remaining in existence until such time that “works” for A in terms of his personal tax position (with the proceeds possibly lent to A for use in the meantime).

71. In such a situation, then the mischief would seem to be the maintenance of Company X in order to defer the timing of recognition for tax purposes, rather than the sale itself. In such circumstances the government should consider trying to combat that deferral rather than the availability of SSE. In this context, a commercial enterprise would look to use the money productively within a reasonable period\(^\text{11}\) or distribute it to shareholders.

72. Any anti-deferral provision should be targeted, and not of general application to all potential SSE cases. The possibility of a re-investment requirement was mooted as part of the original SSE consultation, and rejected by respondents given the compliance issues involved.

73. If, however, the government considers that an anti-avoidance provision within the SSE itself is the better route, then this should be targeted so that it addresses the risk identified by government, and does not extend more widely than necessary.

74. In this context, the issue is then what particular assets/activity the government is concerned about in relation to tax-motivated incorporation – this is not clear from the Consultation. We assume that the risk is the type of activity being “incorporated” not simply the fact that a business has been incorporated.

75. If “passive assets” are the concern, then this could be addressed by a measure similar to that employed by the Netherlands.

76. If the concern links to, say, individuals incorporating their “buy-to-let” property businesses to benefit from SSE, then again a specific targeted provision could be used. For example, the ATED provisions focus on corporate ownership of high-value residential property as the basis for charge, and then disapply the rules for particular categories of corporate owner not intended to be excluded (by reference to the nature of their business activity).

\(^{11}\) For example, the REIT rules recognise the need to hold back funds for reinvestment albeit in a slightly different context. Following a disposal, a 24 month period is allowed, during which the cash proceeds are treated as assets of the exempt property business. After that 24 month period, the cash “switches” to the residual business and, if material, could impact the REIT’s satisfaction of the “assets” condition. See GREIT09005.
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77. In any event, care will be needed to ensure that bona fide commercial activities are not taken out of the regime. This could be achieved, for example, by making the exclusion dependent on (a) the activities of the company and (b) the company being subject to a low rate of tax (in effect adapting, albeit in a more limited way, the approach taken in the UK’s controlled foreign company regime in relation to certain types of exempt activity).

**Tax-free low-tax portfolio income repatriation**

78. The Netherlands’ participation exemption contains provisions intended to address this risk: see Appendix 3. These provisions combine an effective rate of tax test, as well as an “asset” test.

79. We consider a similar approach could be taken in the UK.

80. Given the challenges in defining portfolio investments, we recommend that any exclusion should also include a minimum tax rate test to ensure the exclusion is appropriately targeted.

81. Again, this approach borrows from the CFC rules. As a result, in determining whether income is subject to an effective rate of tax, account should be taken not only of local tax, but also any UK tax charge under the CFC rules on the relevant income.

82. As set out in our response to question 3, real estate should not be regarded as a portfolio asset for these purposes. The risk of tax deferral in relation to real estate is negligible, because countries typically exercise taxing rights on real estate income as it arises.

83. We understand that in the Netherlands, real estate is specifically excluded from being a portfolio investment. To benefit from this exclusion, the Netherlands requires the relevant property owning company to have a certain minimum percentage of real estate assets. Within a UK context, an equivalent condition may be that the relevant company (wholly or mainly) carries on a property business.

**Question 8: Do you consider that the benefits of a comprehensive exemption would be materially reduced if a trading condition was retained at the investee level? Please provide any relevant examples to support this.**

84. Yes.

85. The Consultation Document sets out various factors that are relevant to its assessment of whether to amend the SSE. If the UK decides to introduce a comprehensive exemption to improve its attractiveness as a holding company location, the two key factors are simplicity and competitiveness.

86. The Netherlands and Luxembourg are long-established holding company jurisdictions. Their participation exemptions are well known by businesses and the regimes are easy to understand. If the UK wants to attract holding companies, then it has to offer a comparable regime - both in terms of scope and simplicity. This is essential if the UK is to be able to persuade business of the merits of the coming to the UK, rather than reverting to the “known”. This is particularly the case given the result of the EU Referendum, and the resultant uncertainty as to the UK’s continuing relationship with the EU.

87. However, if the government’s objective is instead focused on facilitating investment decisions by those UK groups that are already within the ambit of SSE – i.e. the principle driver for change is “simplicity” –
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then, as the benefits of the “new” SSE would accordingly be limited in any event, maintaining conditions at investee level may not itself materially reduce the benefits of that “new” SSE.

88. But, limiting any reform of SSE in this way would, in our view, be a wasted opportunity. We consider that a narrow focus on trading activities (as per the current SSE) is not justified: please see our response to questions 3 and 4 above.

Question 9: Are there alternative tests at the investee level that would still provide sufficient protection against abuse?

89. See our response to question 7.

Question 10: What benefits would there be in focusing the investing and investee conditions on the companies involved in the transaction? How could such a change be protected from abuse?

90. For the reasons given in response to question 3 above, we recommend that the investing condition is repealed. We therefore prefer Option 2 to Option 4. We are not convinced that Option 4 by itself would meet the stated objectives of any SSE reform outlined in Chapter 3.

91. In any event, we see no benefit in focusing the investing condition on the company making the disposal only. A group will often separate out particular activities under intermediate holding companies. If Option 4 applied the current SSE tests, then where an intermediate holding company is the seller, it is unlikely to meet the investing condition after the sale\(^\text{12}\) - even where the overall group was a trading group (within the SSE).

92. The Consultation acknowledges that the government “would need to consider how non-trading holding companies of a trading group/sub-group would be accommodated under a company-level test” if Option 4 were taken. However, given that intermediate holding companies are common within corporate groups, this comment itself indicates that a focus on the seller is unlikely to be workable in practice.

93. We also consider that, as far as the investee condition is concerned, this should continue to look at the sub-group, and not just the company, being sold. For the reasons given in response to question 11, we support an extended definition of qualifying activities at investee level (as suggested in Option 3).

94. If the government decides to limit any reform in the manner suggested by Option 4, we would recommend that, rather than focus on the (immediate) companies involved, it instead looks at ways of ensuring the availability of SSE is contingent on factors over which a UK company has oversight.

95. The SSE tests require taxpayers to look at the position of the overall group. For example:

(a) Holdco is the parent of a multi-national enterprise, with subsidiaries in the UK and globally.

(b) Holdco has a UK subgroup that is trading, held under an intermediate UK Holdco.

\(^{12}\) The only possible way of satisfying the “trading test” immediately after the disposal would be if the liquidation exemption applied: but, as the CBI point out in their response, this is not a complete solution in any event.
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(c) Activities outside the UK are more mixed (and so may not satisfy the 80/20 test).

(d) If Holdco decides to sell certain UK trading operations, it needs to look at all of its operations (wherever situated) to assess whether it is entitled to UK tax relief in respect of a limited subset of its activities in the UK. This is a cumbersome exercise.

(e) Even if the (continuing) UK subgroup remains a trading group, the non-UK activities could mean that relief is not available.

96. In this situation, and assuming the trading condition remains, it would be helpful if Holdco could elect to test SSE eligibility by reference only to the UK subgroup from which the disposal is being made. This could simplify the process of testing SSE eligibility, and potentially improve certainty as a result.

97. In some cases, this may mean that a group benefits from SSE in circumstances where, absent the election, it may not have done. Further, a group may decide not to make the election if the nature of its UK-owned activities means it might fail SSE - but here a group is in no different a position to that which applied under the current regime (and so we see negligible risk of avoidance opportunities by making this elective), and we view it as important that any reform following from this Consultation extend the scope of SSE and not restrict it.

98. We understand that the Irish participation exemption - which is only available to trading groups - looks at the activities of the Irish holding company and its qualifying subsidiaries only in testing the “trading condition” - and not those of “sister” subsidiaries.\(^\text{13}\)

Question 11: Are there changes that could be made to the definition of qualifying activity that would help to better deliver the SSE’s policy objectives while maintaining sufficient protection against abuse?

99. We recognise that Option 3 allows the government to limit the activities that benefit from SSE “upfront”, rather than relying on a list of exclusions. Such an approach may have the merit of being “clearer” to business, as to the scope of a reformed SSE.

100. We consider property rental business should be one of those activities. We note that property businesses have been able to benefit from reconstruction relief for some time\(^\text{14}\), and we see no justification for treating them differently for the purposes of SSE. We also welcome the government’s willingness to consider moving away from the trading/investment distinction.

101. In this context, we note that the government has itself recognised the “active” nature of property businesses and their alignment to trading operations. As part of its lengthy consultation on modernising the corporation tax system in 2002 to 2005, the government proposed a new “source” under the schedular system for profits of an operating business. The intention was to create a new source out of trading and property rental business income for companies, recognising the commonality between such

\(^{13}\) Source: PWC Worldwide Tax Summaries 2015/16: Ireland.

\(^{14}\) In this context, a formal clearance procedure applies to section 136 Taxation of Chargeable Gains Act 1992. Although it is limited (by statute) to confirmation that a transaction is for bona fide commercial purposes, in practice comfort can be obtained from the clearance procedure that relief is available on the facts. SSE is self-assessed: therefore the lack of clarity within CG52709 on what is a business is not appropriate for SSE.
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commercial activities.\textsuperscript{15} We see no reason why this commonality should not now be recognised within SSE.

102. In amending the SSE to incorporate a broader range of qualifying activities, it would not be helpful to replace this with an active/passive distinction: this could lead to uncertainty as to what counts as “active”, meaning that businesses are dependent on available guidance in working out whether it is “in” or “out”. Ultimately, any such test will involve an element of subjectivity, making it difficult to apply in practice. This could mean that clearances become even more common, creating resourcing issues for HMRC.

103. This is particularly the case within a CRE context. The range of management activity involved in operating a property business will depend, for example, on the nature and condition of the property, the nature and number of occupiers and the terms of the lease. For single-occupier office buildings, the tenant may assume much of the day-to-day responsibility for the building: here, the landlord would have been “active” in attracting that tenant. The position would be different in a multi-tenanted property where tenants are on short leases, where “active” marketing would be on-going as tenants come and go\textsuperscript{16}. Similarly an owner of a property that is in need of refurbishment may need to be more “active” (in terms of organising works etc) than an owner of a relatively “new” property.

104. There is also a difficulty in that, for commercial reasons, property groups often include single purpose property owners. These companies generally delegate property management to a group management company. This allows the group to centralise the management function, achieving economies of scale - and may also be required under the terms of financing arrangements.\textsuperscript{17}

105. This also means that across the group there will be a mix of activity: some companies will be involved in development (directly or through a joint venture (JV)), others will be in marketing mode to find tenants whereas others will be “light touch” where an occupier has assumed a full repairing lease. Over a property’s life cycle, a company may have been involved in all these activities: should a company fall outside a definition of qualifying activities simply because its initial development and marketing activity was so successful that in the relevant 12 months qualifying period, its main activity has been managing the common parts and invoicing rent\textsuperscript{18}?

106. In addition, notwithstanding the variance in (actual) activity levels at any particular time in a property’s life, property rental businesses operate as productive commercial enterprises, with management teams using their expertise, experience and skill to invest productively within the built environment.

107. The original consultation on SSE in June 2000 explained that the government wanted to promote innovation and modernisation in productive businesses. UK CRE is a productive business, both in its own right, and in the importance of the services it provides to businesses across the spectrum. CRE businesses are essential in providing other businesses with high quality accommodation - helping deliver economic benefits, jobs and growth within the UK.

\textsuperscript{15} See Corporation Tax Reform: Technical Notes December 2004. The reform was not proceeded with as most respondents considered it was simpler to stay with the system they knew in the absence of a broader reform (ie abolition) of the schedular system.

\textsuperscript{16} This will be particularly the case in the residential sector (ie PRS projects).

\textsuperscript{17} Lenders do not want responsibility for employees in the event of a default.

\textsuperscript{18} Although this itself can involve a significant amount of work where, for example, a property is part of an estate or campus development, with common parts extending to external spaces and infrastructure.
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108. Given the UK’s schedular system, and the resultant characterisation of particular activities for tax purposes, we consider that Option 3 should instead look to define the activities that are to be within SSE without requiring any judgments as to active or not.

109. In relation to the risk of avoidance, the comments made in response to question 7 equally apply here. It would be possible to adapt the types of condition outlined there to form part of any definition of any proposed “good” SSE activities.

Question 12: In what situations does the definition of a substantial shareholding prevent large and long-term investments benefitting from the SSE? What is the case for these situations being accommodated?

110. No comment (in relation to the specific question).

111. Question 12 is directed at Option 5 (the possibility of reducing the SSE minimum shareholding requirement to less than 10%). Our view is that other reforms to the SSE should be prioritised ahead of Option 5.

112. We are not aware of specific difficulties with having a minimum 10% holding in practice. The government has highlighted coherence as an objective of any reform and we can see arguments for retaining that 10% shareholding requirement on grounds of coherence given that for the purposes of the distribution rules in Part 9A Corporation Tax Act 2009, a portfolio dividend is defined by reference to a holding of less than 10%.

113. Plus, in terms of competition, although the Netherlands, France and Ireland all have a minimum 5% shareholding requirement, Luxembourg’s conditions include a 10% requirement. The UK’s competitiveness would not necessarily be damaged by retaining a 10% shareholding requirement.

114. If a 10% shareholding requirement is retained, we agree with the CBI that it is important to ensure that fractured ownership of that minimum shareholding does not prevent a UK company benefitting from SSE in respect of its (part) stake. The SSE rules allow aggregation of group holdings: however the definition of group used for SSE purposes is a capital gains group, which is less flexible (and more formalistic) than other group definitions in terms of tracing indirect ownership.

Question 13: What other substantive reforms could be considered to make the SSE simpler, more coherent and more internationally competitive?

115. The SSE currently applies to a qualifying disposal of shares in a company only.

116. Given the different options available to business in selecting a business form for activities, we consider that the government should extend SSE relief to interests in other (opaque) business entities commonly used in corporate structures.

117. Examples of such entities include unit trust schemes and also the recently introduced co-ownership Authorised Contractual Scheme (CoACS), which are transparent for income purposes. These types of

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19 For completeness, Luxembourg also offers exemption on gains where a holding is less than 10%, but above a certain minimum value that gives some flexibility to groups.
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entity are commonly used in real estate holding structures, including JVs or other co-investment, as non-residents value the income tax transparency.

118. This tax transparency means that a UK owner of an interest in such an entity would be effectively taxed on the income as it arises (one of the parameters listed in relation to Option 1). If SSE is extended to apply to property businesses, we consider that the government should consider allowing gains on substantial holdings of interests in such entities to be exempt from CGT under SSE.

**Question 14: Is there a case for reform of the SSE to be targeted towards the funds sector? How could SSE-qualifying funds be defined for this purpose?**

119. As stated above, we consider that the government should broaden the scope of SSE generally, following Option 1 or Option 3. On this basis, it should be possible to craft the relief so that a fund’s holding company can benefit from SSE on disposing of investments in the special purpose vehicles that own particular property (and other) businesses. From a CRE perspective, this would be beneficial as it would ensure a level playing field among different types of CRE investors (whether fund, UK property group or REIT).

120. However, if the government decides to implement a more restricted reform of SSE, we recognise that there are specific issues relating to the funds sector that suggest a more targeted reform of SSE would be appropriate as an interim step as part of a longer-term reform strategy (see our response to question 4).

121. Please see our detailed comments at Appendix 4 on the issues relating to creating a targeted SSE for funds.

**Question 15: To what extent does the SSE’s focus on ordinary share capital in determining the members of a group create complexity or lead to results that are inconsistent with the policy objective?**

122. Given the variety of business structures available to businesses that operate globally, other forms of ownership interest (and not just ordinary share capital) should be used in determining grouping for SSE purposes.

123. In addition, the definition of a group for SSE purposes is a CGT group, albeit substituting 51% for 75% in terms of ownership requirements.  

124. The capital gains group definition is relatively formalistic. It operates on a cascade basis (with the effective ownership test being the only link back to the parent company.) It therefore differs from other group definitions (such as group relief group) and also from the increasing reliance on accounting consolidation tests within UK tax legislation (e.g. worldwide debt cap and the proposed interest restrictions).

125. We would recommend that any follow-up consultation on the detail of SSE reform considers whether “group” for SSE purposes should be defined in a different way. In particular, membership of a CGT group is of no direct relevance to non-UK companies. For international groups, a definition that moved away

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from a technical UK tax term - to something that was more reflective of commercial reality -could be helpful

126. In any event, if – as we recommend - Option 1 is adopted, a definition of group may be redundant.

Question 16: In what situations could delays in the sale of a residual shareholding result in the loss of SSE treatment, and how should this be rectified?

127. No comment.

Question 17: In what situations can the post-sale trading requirement create issues that are not accommodated by the existing winding-up provisions?

128. For the reasons given in response to question 3 above, we recommend that the investing condition is repealed. If the investing condition is repealed, then the post-sale trading requirement for the investing company would no longer apply.

129. If the trading condition remains, we consider that the post-sale trading requirement for the investee company should be tested solely by reference to the company (or sub-group) that is transferred to the buyer, and not by reference to the wider buyer group. As stated in our response to question 3, we consider the focus of SSE should be on the company (or subgroup) being sold, and not the broader group of which it is part.

130. Further, as a policy matter, what happens after the point of sale should not impact on the seller’s ability to obtain SSE.

Question 18: Are there other areas of the SSE legislation that you consider to be ambiguous or producing outcomes that are inconsistent with the policy intention?

131. The trading activities test leads to uncertainty for businesses. We would therefore welcome any reform that resulted in a simpler test that was easier to apply in practice, and allowed groups to obtain the certainty they need when making decisions.

132. Even though some of the Options would remove the trading activities test, it will be important to ensure that similar issues do not arise under any replacement “qualifying activity” based test.

133. The difficulty is clearly identifiable in HMRC’s published guidance on SSE:

“Whether during any particular period or at any particular time a company, group or subgroup satisfies the requirements will depend on the facts. What did the activities of the company during that period or at that time include? The status of a company, group or subgroup can change as the activities that are being carried on change so it will not normally be possible to predict with certainty what the status may be at some future time.”

21 See HMRC Capital Gains Manual at CG53100.
134. It is this lack of an ability to “predict with certainty” whether a company may qualify for SSE or not that is a key challenge for groups in making rational decisions about restructuring and disposing of subsidiaries. The focus not only on facts, but also on the inference to be made about those facts based on surrounding circumstances, can result in uncertainty for business. As the guidance notes at paragraph CG53116: “Most companies groups and subgroups will have some activities that are not trading activities.”

135. The “balance of indicators” approach and the focus in the guidance on drilling down to individual items of detail, together with the guidance’s emphasis on the 80/20 “substantial extent” test as a “cliff-edge”, add to this uncertainty. This in turn leads to groups looking to HMRC to provide clearances that SSE is available as a matter of course. This not only gives rise to frictional costs for businesses, but also raises resourcing (and opportunity costs) for HMRC.

136. Plus, any clearance is time-limited: HMRC cannot confirm future status.

137. The lead in for a significant corporate disposal can be significant. It is possible that the factual position at the point a group decides to pursue a particular strategy may not be the same as when the resultant disposal takes place - particularly if the group has a large number of subsidiaries in different jurisdictions, with the facts constantly changing. Therefore the timing of any clearance application has to be considered carefully: both ensuring that the clearance covers the appropriate qualifying period, but also that the minimum 30 day response time does not delay the deal.

138. Further, the path of corporate disposals may not always run smoothly: parties can be near to agreement, and then the buyer can walk away. The process has to restart, and the SSE evaluation undertaken anew.

139. As a result, in any reform, the government should look to making any activity-based test (whether by way of inclusion in, or exclusion from, the regime) as targeted and clear as possible to minimise these uncertainties. We recognise the challenges inherent in providing certainty within statutory definitions (given the concepts involved) and appreciate that it may be necessary, in order to provide flexibility, to rely on guidance.

140. The current guidance is however limited in terms of the help it gives. As the SSE has been in operation for 14 years and HMRC will have considered a significant number of clearance applications in that period, we would ask that the guidance be updated to provide “real life” examples of how the test has been applied in practice.

141. In addition, if the trading condition test is retained, the government should consider amending the “to a substantial extent” test to a “wholly or mainly” test, which is used in other tax contexts. This would lower the threshold to 70% (based on how it is commonly applied elsewhere) and would by itself give a little more flexibility around the “edges” for groups.

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22 See HMRC Capital Gains Tax Manual at CG53116.
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Appendix 2: Diagram of (example) property group structure

Non-Holding Company
1. A holding company is required in order to consolidate all of the underlying real estate investments. The administration and financing of the property portfolio may also be carried out by the holding company.

2. Any double tax treaty claims applied for in respect of WHT suffered on the distributions received from the underlying investments are claimed by the holding company. This is an important function of the holding company as it is administratively simpler for one company to reclaim the WHT suffered, rather than each individual investor making a treaty claim. Individual investors may not have expertise to submit a treaty claim and it may not even be economically viable to do so on their portion of profits.

3. It is not uncommon for a local holding company to be used in the same jurisdiction as the investment, as illustrated with the investment in Country A.

UK Group Sub Non-Holding Company
4. A holding company is required in order to consolidate all of the underlying UK real estate investments. The administration and financing of the property portfolio may also be carried out by the UK holding company.
SPVs and investments

5. Individual real estate assets are often directly owned by a special purpose vehicle or holding company, often (but not always) in the same country that the asset is located. This allows flexibility when selling the asset e.g. the ability to sell a proportion of the asset rather than the whole asset. It also allows for specific borrowing at the level of the asset if required.
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Appendix 3: Summary of participation exemption regimes in Netherlands, Luxembourg and Ireland

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Ownership Requirement</th>
<th>Minimum Period of Ownership?</th>
<th>Other Conditions?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Netherlands²³</td>
<td>5%</td>
<td>None</td>
<td>Purpose test:</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(a) Is the parent looking to add value to its subsidiary, rather than just holding the shares to generate a return that may be expected to be generated from normal asset management?</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(b) Not more than half of the subsidiary’s assets must be minority (5% or less) stakes in other companies</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>(c) The subsidiary must not predominately perform financing, leasing, or licensing activities for affiliated entities.</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>Subject to tax test:</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>The subsidiary should be subject to an effective rate of tax of at least 10%.</td>
</tr>
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<td></td>
<td></td>
<td></td>
<td>Asset test:</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Less than half of the subsidiary’s assets must be portfolio low-taxed assets.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>An asset is a portfolio low-taxed asset if:</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(a) the asset is a passive investment and not reasonably required in the entity’s business activities; and</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(b) the effective tax rate for the income from</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage</th>
<th>Time</th>
<th>Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ireland</td>
<td>5%</td>
<td>12 months</td>
<td>Exemption only available to disposals of a subsidiary which carries on a trade or where the activities of the seller and all of its 5% subsidiaries taken together amount to trading activities. The company being sold must be EU resident or resident in a jurisdiction with which Ireland has a double tax treaty. The company being sold must not derive its value from land situated in Ireland.</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>10% or (if lower) the shares have an acquisition price of at least €6m</td>
<td>12 months</td>
<td>If subsidiary is neither a Luxembourg company nor an entity within the scope of the EU Parent/Subsidiary Directive, then it must be subject to corporate income tax comparable to Luxembourg tax (with a minimum of 10.5% rate) to qualify for exemption.</td>
</tr>
</tbody>
</table>

Note: Real estate assets are not portfolio low taxed assets.

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Appendix 4: A Targeted SSE for funds: comments

1. Our view is that any reform of SSE should be universal - in that it should apply both to corporate groups and funds.

2. That said, we recognise that there are specific issues relating to the funds sector that suggest a more targeted reform of SSE would be appropriate as an interim step as part of a longer-term reform strategy. This would allow the government the opportunity to consult further on how best to effect such reform.

3. In particular the government has identified BEPS as a potential driver for reviewing the application of SSE to funds. Although BEPS6 will be relevant to corporate groups as well as to funds, we note that funds could be particularly affected given the lack of clarity around how the measures will apply to non-CIVs.

4. Offering global funds a competitive participation style regime could therefore assist in attracting such funds to the UK as the basis for a holding platform. It would enable them to align their holding structures with their existing UK asset management activity.

5. However, a fund’s choice of holding jurisdiction will be influenced by other commercial and regulatory factors.

6. Funds will look to use, so far as reasonable, a tax efficient structure to holding its investments, so as to optimise returns to investors. In some ways, the aim is to get as close as possible to the position that the ultimate investors are taxed as if they had directly made the relevant investments. Any tax incurred by the fund (at any level in the holding structure) reduces the return for investors - an additional cost which in many cases would not have been incurred had the investor held the investment directly.

7. In making such a comparison between different jurisdictions, managers will balance a number of factors, tax and non-tax. On the tax side however relevant issues will include the extent (and scope) of double tax treaty networks, the availability of capital gains exemptions/reliefs on disposals, dividend taxation, withholding tax treatment of both dividends and interest payments to investors and the nature of any applicable CFC rules.

8. In the context of private equity real estate (PERE) investment, funds generally have a limited life of no more than 10 years (though this will not be the case for all funds, nor for holding platforms set up for a particular investor).

9. The uncertainty caused by the result of the EU referendum may therefore deter some fund managers from establishing new funds in the UK until there is greater clarity regarding the relationship between the UK and other EU countries (including the status of EU Parent/Subsidiary Directive and the AIFM Directive) to warrant a decision to set up a UK holding platform. As clarity emerges, managers may be more likely to consider the UK as a possible holding jurisdiction for new funds, provided the UK offers a regime that is comparable (and potentially improves on) what is available elsewhere.

10. Those funds that are set up for a single (long-term) investor may take a different view: such funds will be more focused on that investor’s objectives, rather than meeting pre-agreed targets as marketed to a pool of investors.
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11. In any event, the importance of simplicity cannot be underestimated. Within the EU, there are a number of well-known holding company jurisdictions that simple and clear participation exemptions that are available generally (and not to defined types of fund). Therefore it is key that any funds-only SSE defines “fund” in a way that is clear and easy to apply in practice.

12. In the Consultation, the government lists various factors that could support a case for targeted SSE reform and asks for views on the criteria that could be used to define funds for these purposes.

13. Global funds will have a diverse investor base, most of which will be non-UK residents, and some of whom may be tax-exempt (whether pension funds or sovereign immune investors). The principal purpose of such funds is to allow investors to pool capital and gain efficient access to professional management and diverse assets.

14. As set out above, the manager will aim to set up a holding structure that is as close as possible to the position that the ultimate investors are taxed as if they had directly made the relevant investments to avoid subjecting investors to costs that would not have been incurred had the investor held the investment directly.

15. As a result, fund managers would generally not look to make an investment through a UK company that could be subject to CGT on any future disposal of that investment - particularly given the number of jurisdictions that can provide similar advantages to the UK, but without the potential tax charge. Removing that potential CGT charge removes one of the UK’s main disadvantages as a holding jurisdiction for such funds.

16. On this basis, it seems reasonable to assume that the policy costings for a relief targeted at such funds would presumably show no cost to the Exchequer in terms of foregone revenues. However we do not consider that the tax profile of the fund (or rather its investors) should form any part of the criteria for such a relief.

17. Instead, the conditions of any relief should be based on objective criteria, that are easy to apply and clear in their terms. A targeted relief should therefore seek to define a “fund” by reference to specific characteristics.

18. The Consultation comments on “the reduced avoidance risk” that would come from applying the relief to funds that exhibit three characteristics: widely held, regulated and subject to minimum distribution requirements.

19. We assume that the government’s concern here is to ensure that a fund SSE could not be used by individuals to “envelope” their personal portfolios within a fund structure and thus avoid CGT that would otherwise be payable: the same concern discussed in the Consultation in relation to Option 1.

17. We consider that a “widely held” condition should be the most important factor in determining whether a fund should be entitled to SSE.

18. Where a fund is genuinely widely held, the risk that any individual investor (or small group of them) could influence the structure or investments of the fund to facilitate their own tax advantage is significantly mitigated. Therefore, we consider that the requirement for a fund to be “widely held” would protect against the risk of abuse.
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19. If a widely held condition were introduced, any threshold must take account of the nature of the investors as much as their number. This is important if the relief is to be successful in attracting funds to the UK because it is not uncommon for real estate funds to have less than 10 investors.

20. For example, if investors are themselves widely-held entities, a fund with a sufficient level of such investors should itself be considered widely-held. We would recommend that a version of the close company rules which is used in the UK REIT legislation is used for this purpose. This would allow a fund to be deemed to be widely held if it is controlled by an institutional investor that is itself widely held.

20. We do not consider that fund regulation should be a condition for SSE - or that it would be particularly useful in terms of addressing a perceived avoidance risk. Most property funds of the type described in the Consultation are non-CIVs with sophisticated investors and so are not themselves regulated (although the manager is usually regulated). The status of such funds from a regulatory perspective is very different from that of “retail funds”, which are subject to investor regulation given that they are open to investment by the general public.

21. Imposing a minimum distribution requirement as a condition for SSE eligibility would be problematic for many real estate funds. While funds that focus on ‘core’ real estate with stable income and long leases generally do make regular distributions to investors, many others – especially if they focus on refurbishment/redevelopment opportunities – do not.

22. This behaviour is not tax motivated but rather arises from their business strategy, which is to maximise returns to investors (often over a pre-determined and fixed time period, say 8-10 years) by ‘adding value’ to properties that may be in need to significant amounts of capital expenditure or asset management to make them attractive to occupiers.

23. This strategy may involve periods in which relatively little income is earned and therefore there is little to distribute to investors. Any spare income that arises in such funds is often reinvested into new assets, used to repay debt or used to fund capital expenditure somewhere in the fund’s portfolio.

24. In any case, real estate income and gains are typically taxable in the country where the real estate is located as they arise; it is therefore difficult to see how income could be ‘rolled up’ in a tax-free way by a property owning company with a view to effectively converting income derived from the asset into a capital amount. It is not clear to us why regular distributions to investors should be a pre-condition of qualifying for SSE.