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## Association of Real Estate Funds

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The Association of Real Estate Funds (AREF) represents the UK real estate funds industry and has around 60 member funds with a collective net asset value of more than £64 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the MSCI/AREF UK Quarterly Property Funds Index and the MSCI/AREF Property Fund Vision Handbook.

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## Our Response

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Thank you for the opportunity to respond to this joint consultation from HM Treasury and HMRC on the VAT treatment of fund management services. We welcome the chance to help contribute to crafting new legislation to improve policy clarity and certainty for all industry stakeholders.

To begin our members are disappointed that the consultation, as a starting point, does not seek to address the role VAT has within the fund management sector and 'that options for policy reform in relation to fund management services do not fall within the scope of this consultation'. We continue to urge Government to look at the case for zero-rating of fund management fees, with a view to levelling the playing field between onshore and offshore investment structures and believe many of the technical issues identified within this consultation would be solved through the introduction of zero-rating. We have however sought to constructively engage with the points the consultation raises and, where applicable, comment on their effects for property funds and our members.

The mechanics of input VAT recovery and the role VAT plays in the setup and running of UK property funds differs substantially compared to funds investing in other asset classes. In particular, it is standard practise for most UK property funds to register for VAT and opt to tax properties within their portfolios, which means that such funds can recover some or all of the VAT incurred in respect of management and other services received. Nevertheless, uncertainties in the VAT treatment of management services remain a significant complication in property funds. Even where, due to input VAT recovery, there is no net Exchequer impact, the classification of services as VATable or exempt can lead to compliance issues for funds and managers.

Our members understand that while the UK will no longer be bound by the VAT Directive the option to tax rules contained within VAT Act 1994, Schedule 10 Part 1 will remain, and this is not within the scope of the Retained EU Law (Revocation and Reform) Bill. To this extent then we believe the consultation will likely maintain the practical status quo for UK property funds but we are concerned that the principles test set out in paragraph 2.3 of the consultation document is both unclear and appears misaligned with the general concept of the exemption and the likely effect it will have for future fund types.

In determining the appropriate legal and regulatory structure for an investment fund, a range of factors are considered including the types of investors the fund wishes to attract, their need for liquidity, and the assets the fund will hold. While different legal and regulatory forms will naturally have differing tax treatments, in our view the tax system should in principle not be a driver of the choice of structure – as far as possible, the tax system should be designed so as to provide a broadly tax neutral outcome whatever the choice of structure, except in cases where the

Government determines that there are good economic policy reasons to encourage one investment structure over another. Differences in tax treatment between choices of structure tend to lead to artificial choices that are not economically optimal.

In our view, the objectives of this consultation should be:

- To provide certainty to funds and their managers of the VAT treatment of fund management services.
- For the VAT treatment to be based on the nature of the services provided, and not the legal or regulatory form of the investment vehicle.
- To provide an internationally competitive tax regime that will encourage funds to be established in and/or managed from the UK.

We do not consider that the proposals achieve these objectives.

Limiting the list of exempt fund types in Items 9 and 10 of Group 5, Schedule 9 of VATA to those already on the list and requiring any new fund types to rely on the criteria defining a SIF, mean that there will remain significant uncertainty for new fund types as to whether management services will qualify as exempt. This will create an incentive for funds to be established with structures from the existing list rather than alternatives with uncertain treatment. It will also limit the ability for the Government to introduce new fund types in future as their launch will be complicated by questions over the VAT treatment.

The criteria set out for a fund to be considered a SIF are likely to create considerable uncertainty. The definition of a collective investment scheme is complex and it is not always clear whether a fund meets this requirement, particularly in the property or real assets sector where funds are often closed-ended, or provide limited liquidity or 'evergreen' structures.

More importantly, criterion d) is likely to be very difficult to apply as it is a subjective judgement as to whether a fund that is not a UCITS fund nevertheless is subject to the same conditions of competition and appeal to the same circle of investors as a UCITS. There is no clear distinction in the market between the types of investors that invest in UCITS and those that invest in non-UCITS funds. The equivalent test in the European VAT Directive has been the subject of many European Court judgements and continues to provide uncertainty for funds. It is likely that similar litigation would arise under this test, or that funds will choose not to establish themselves in a form that is subject to this test.

#### *Impact on the Professional Investor Fund ('PIF')*

AREF has been leading the introduction of a new fund type to add to the UK's repertoire of investment vehicles – an unauthorised co-ownership AIF (referred to in Financial Services and Markets Bill<sup>1</sup> being progressed within the UK Parliament as such, however known in the market as a Professional Investor Fund or 'PIF') – and we welcome the commitment by HM Treasury as part of the UK Fund Regime Summary of Responses to support the launch of the

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<sup>1</sup> [https://publications.parliament.uk/pa/bills/cbill/58-03/0181/amend/finserv\\_pro\\_rep\\_1207.pdf](https://publications.parliament.uk/pa/bills/cbill/58-03/0181/amend/finserv_pro_rep_1207.pdf)

PIF<sup>2</sup>. In assessing the characteristics of the PIF against the principles of the newly proposed 'SIF' definition this presents obvious conflicts which we feel should be resolved.

The PIF proposal was designed very explicitly to have a tax treatment that, so far as possible, is similar to the Authorised Contractual Scheme (ACS). The ACS benefits from VAT exemption due to being included in Para 9 as exempt.

For the above reasons, it is not clear whether a PIF would also benefit from exemption under the proposed SIF test, and this is likely to require case-by-case consideration.

In summary these conditions could present a scenario whereby the VAT treatment of PIFs could differ from their ACS counterparts, with some falling under the exemption while others see their supplies of management fees as standard rated. This disparity is likely to create complexity and uncertainty regarding the management of PIFs and potentially differing treatment is may weigh on operators of:

- (i) ACSs when looking to decide on whether to convert to a PIF or
- (ii) PIFs when looking to decide on whether to convert to an ACS (including an ACS LTAF).

More generally in this connection (and although this is not an issue particular to real estate funds) AREF has a concern that if the new regime is intended to bring clarity of application of the exemption, then the characteristics-based approach as set out in paragraph 2.3 needs to be much more fully and plainly defined. It is especially difficult to know what the meaning of limb (d) is intended to be and what characteristics it encapsulates.

We suggest that UCITS is an incorrect characteristic to link entitlement to the exemption and would highlight that there are a host of AIF funds which are able to avail of the management fees exemption. Domestically these include open-ended vehicles within the NURS, QISs and LTAF regimes and closed-ended entities such as Investment Trust Companies. In Europe both Ireland with their QIAF regime and Luxembourg with their RAIF regime offer exemption to funds covered under AIFMD.

Looking back to the purpose of the exemption, its policy goal has been:

- a) promote access by savers to collective investment:
- b) avoid subjecting contract-based funds to a tax burden which self-managed investment undertakings which are legal entities do not have to bear<sup>3</sup>

To better align the principles test with this ideal we suggest that the condition d) be expanded to include AIFs but with suitable constraints if those AIFs or their operators are already suitably regulated.

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<sup>2</sup> <https://www.gov.uk/government/publications/review-of-the-uk-funds-regime-a-call-for-input>, HM Treasury publication 10 February 2022 paragraph 2.171

<sup>3</sup> Para 26. of Advocate General Poiares Maduro's opinion in respect of the [C-8/03 – BBL](#)

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We note that last summer the UK presented draft legislation for the implementation<sup>4</sup> of the OECD's Pillar Two rules which included a comprehensive definition of what is an 'investment fund'. Within that definition it includes a measure that would require that:

*"the entity, or its management, is subject to a regulatory regime in the territory in which it is established or managed, and that regime includes anti-money laundering and investor protection regulation;"*

We suggest that the 'state supervision' point could be reintroduced and cross referenced to this definition to better reflect current VAT policy and help consistency of treatment across the investment landscape.

This consistency would then ensure a more level playing field, and cut down on possible frictions between investor choice of different investment vehicles that fundamentally perform the same purpose and achieve the goal of ensuring that the exemption should support investment, regardless of the form of the vehicle in which this investment takes.

Thank you for your time and willingness to consult on these measures. Should you wish further engagement on any of the points raised in our response we would be happy to elaborate at your convenience.

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