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ALERT MEMORANDUM

Light on the Horizon for Fund Sponsors

23 December 2020

The UK considers reform of its asset holding company tax regime.

As a turbulent year ends, the UK tax authorities are looking ahead to their legislative programme for the coming year. On 15 December 2020, HM Treasury published a response to its consultation on the treatment of asset holding companies ("AHCs") in alternative fund structures: the full document is available here. Much-awaited, this paper indicates that the UK government sees the case for a new, bespoke AHC tax regime. This has the potential to be a significant development, making the UK a more competitive location for the establishment of AHCs and boosting the UK alternative investment sector.

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The background

Investment funds are usually structured using a partnership (or another similar vehicle that is transparent for tax purposes) to pool the resources of investors. Beneath the fund, sit companies – AHCs – which actually hold the assets in which the fund has invested. The consultation was set up by HM Treasury to explore why those AHCs are not typically established in the UK and whether there is a case for changing the UK's tax rules to encourage greater use of the UK in this context.

Where does the UK stand now?

The UK's current tax rules already have certain attractive features in considering where to establish an AHC. A low headline corporation tax rate (currently 19%), a wide exemption from tax on distributions received, an absence of withholding tax on dividends paid, a good treaty network and a participation exemption from gains on the disposal of certain substantial shareholdings compare favourably with some jurisdictions.

In addition, tax rules globally have shifted in recent years, partially in response to the OECD's 'Base Erosion and Profit Shifting' Project. Showing substance or establishing residence in a jurisdiction away from deal professionals (and the primary fund infrastructure) has become increasingly difficult. Those difficulties have been exacerbated by the travel restrictions associated with the COVID-19 pandemic, which show every indication of continuing in the medium term. Travelling to execute a document or to attend a board meeting is more difficult than it might have been this time last year.

The UK already has a developed financial services industry and a high concentration of asset management activity. Against this backdrop, it may become a logical jurisdiction for combining AHC establishment and expertise in a single place if the barriers to using the UK can be addressed.

What are the existing barriers?

In summarising the features that the fund industry sees as crucial in an AHC, the respondents highlighted the following points:

— As a key principle, the idea that an AHC is an intermediate entity in the investment process. Its use should not result in investors being in a materially worse position (from a tax perspective) than they would have been in had they invested directly in the underlying assets.

— The tax payable by an AHC being predictable and commensurate with its intermediate role.

— The ability to return profits on the disposal of assets to investors as capital rather than as income.

These factors are present in other jurisdictions currently used for AHCs, but the responses indicate that (in varying ways, which the paper sets out in greater detail) they are not perceived to be consistently present in the UK.

What does the UK intend to do about them?

The government sees a clear case for reforming the existing rules and creating a specific, new tax regime for AHCs. Its view is that a bespoke regime, rather than incremental changes to existing rules, will allow the barriers to UK establishment to be addressed most effectively. In addition, a bespoke regime allows tax reforms to be targeted towards companies carrying out specific functions, or which exhibit particular features.

The response paper contemplates the following measures to address the barriers identified:

— A potential exemption from UK withholding tax on interest, specific to payments by qualifying AHCs.

— The potential to allow deductions for amounts of income paid by an AHC to investors that would currently be treated as non-deductible distributions (e.g. payments of interest on results-dependent debt).

— The requirement that a 'taxable margin' be left in an AHC with the margin being commensurate with its role.

— A new relief for gains on disposals of investment assets by a qualifying AHC (rather than changes to the UK's existing substantial shareholding exemption). This may be coupled with a mechanic to capture and tax cumulative untaxed gains if an AHC leaves the regime in the future. It is also unlikely to apply to disposals of UK real estate.

— Mechanics to ensure that, for investors who are UK taxpayers, amounts that are deducted from an AHC's taxable income and paid to investors are treated as income in the hands of those investors. Similarly, amounts that are derived from gains realised by an AHC should be treated as gains in the hands of investors.

— A further consultation on changes to the existing rules for UK REITs rather than a specific set of rules for AHCs that invest in UK real property.

— A call for further evidence in some areas. These include the extent to which an exemption from tax for profits from an overseas property business (which may well be subject to tax in the jurisdiction of the relevant property) would make the UK a more competitive location for AHCs.

Who will benefit?

As with any proposed tax reform, the devil will be in the detail. Accordingly, attention is likely to be focused on the eligibility criteria for any new regime. These criteria will need to perform a balancing act between making the rules easy to operate (and enticing to the fund industry) without eroding the UK's existing tax base.

In particular, the response paper expresses the view that the case for bespoke rules for AHCs is clearest in cases where diverse or institutional investors pool their capital to be managed by an independent, authorised or regulated asset manager. These structures are perceived to contain a layer of existing safeguards against abuse. Accordingly, the proposal is that the government will attempt to identify the 'hallmarks' of such arrangements in framing what allows an AHC to qualify for any new regime.

The government, therefore, envisages the need for rules to achieve four key objectives:

— **Set criteria for the investors making investments via an AHC.** These appear likely to be drawn to ensure that the fund — and hence an AHC — is not controlled by a small number of investors other than institutional investors.

— **Specify how the investors should be identified.** The existing UK tax concept of 'participating' in the results of the investment assets acquired by the AHC is under consideration (meaning, for example, that lending at a fixed interest rate would be regarded differently from a results-dependent loan).

— **Identify and set criteria for the asset manager.** Part of the proposal is that the manager of investment assets held by an AHC should be distinct from the investors. This would mean setting upper limits on the proportion of an AHC that could be owned by asset managers and their individual executives (e.g. through carried interest arrangements).

— **Circumscribe the character and activities of an AHC.** Here, the government starts from the premise that an AHC regime should apply only to entities that are set up to facilitate the flows of capital, income and gains between investors and assets. It is considering borrowing from the regulatory definition of a 'collective investment scheme', and also whether to specify that an AHC cannot carry on a trade. This would potentially prevent a number of private equity portfolio companies from being able to qualify as AHCs.

What are the next steps?

The paper concludes by seeking further stakeholder input on the detailed design of the new regime. This second phase of consultation is due to run until 23 February 2021. Draft legislation will then be published for technical consultation.

The government appears to be receptive to the objectives, views and concerns of the funds industry, which is welcome and a cause for optimism. However, it remains to be seen whether the government is able to implement those objectives, views and concerns, as well as its own, in a way that is as clear and workable as the industry (and its advisors) would hope. Clarity and simplicity, in any new regime, are likely to be key to attracting AHC establishment to the UK.

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