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ALERT MEMORANDUM

A More Concrete Path to a UK Asset Holding Company Regime for Alternative Investment Funds

July 23, 2021

On 20 July 2021, HM Treasury published a response to its second stage consultation on the treatment of asset holding companies ("AHCs") in alternative fund structures (the "response paper"). The response paper confirms the UK government's intention to introduce a new elective tax regime for "qualifying" AHCs, to take effect from April 2022. It was published alongside draft legislation and builds out some of the detail about how that new regime is likely to look.

Further work remains to be done to resolve open items, and further legislation is expected in the autumn, covering elements of the regime not addressed in the current draft. From the detail provided so far, the proposal overall is welcome, if somewhat narrower and more complex than regimes applicable to AHCs in other countries.

In addition, the government will be moving forward with reforms to the UK's real estate investment trust ("REIT") regime, also discussed in the response paper. This bulletin sets out a high level summary of the main AHC proposals only.

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The background

Investment funds typically use a tax transparent vehicle to pool the resources of investors, but non-transparent AHCs (sitting beneath the fund) to hold the assets in which the fund has invested. As part of Budget 2020 the government announced a consultation to explore why, despite the UK tax system having certain attractive features, AHCs are not typically established in the UK.

The response to that first stage consultation was published in December 2020. Indicating that it saw the case for a new, bespoke tax regime for AHCs, HM Treasury launched a further consultation on the potential design of that new regime. It is the findings of that further consultation that have now been published, together with draft legislative clauses for review and comment.

What are the objectives of the new AHC regime?

The response paper indicates that the government has sought to balance a range of factors when designing the new regime. The intention is to attract AHCs to the UK and to build on the existing depth of asset management expertise. As such, the new rules need to be sufficiently attractive compared to the rules in the jurisdictions in which AHC establishment is already concentrated, such as Luxembourg. However, HM Treasury is also mindful of the potential Exchequer impact of generous tax breaks for the funds industry, together with the risk of tax avoidance and the need to adhere to the UK's international commitments and tax standards.

How would the proposed new rules work?

Eligibility

The proposed new rules are centred on the concept of a "qualifying" AHC (or "QAHC"). To be a QAHC, a UK-resident company will need to meet a series of eligibility criteria, summarised below. Eligible companies will also need to elect in to the QAHC regime, in order for it to apply.

— Ownership. The rules will categorise investors in an AHC in two ways: "category A" or "category B".

  As currently drafted, category A includes diversely owned "qualifying funds", defined in accordance with existing collective investment scheme and alternative investment fund rules. According to the response paper, the government also intends that where funds are required to have a regulated fund manager to meet regulatory requirements, that manager must be independent. It has not yet been determined how to deal with funds that do not have managers but would be required to do so by UK law, if the fund were marketed in or otherwise had a connection to the UK.

  Category A also includes certain institutional investors, namely investors with sovereign immunity, managers and trustees of pension schemes (except for investment-regulated pension schemes such as SIPPs), authorised long-term insurance business entities, REITs (both UK and overseas equivalents) and other QAHCs.

  Any investor not expressly within category A will be a category B investor.

  The government proposal is that, to be capable of becoming a QAHC, AHCs will require at least 70% ownership by category A investors (either directly, or via another QAHC). To test the quantum of the investment interest held by a particular investor, the rules will look to familiar concepts of (i) voting rights, (ii) entitlement to distributions and (iii) rights to assets on a winding up. Category A investors will have the lowest of the three numbers obtained by applying these concepts attributed to them; category B investors will have the highest number of the three attributed to them. Direct and indirect interests held by a particular investor (and their connected persons) will be aggregated, and special rules will apply where certain categories of assets or profits of an AHC are treated in a non-pro rata way because of the AHC's capital structure.

  The 70% figure is higher than many stakeholders had hoped, but appears to be aimed at preventing a scenario where a category B investor has significant influence over a QAHC.

— Role and activities of the AHC. To be eligible to become a QAHC, all or substantially all of the activities of the AHC must consist of investment activities undertaken with the aim of spreading investment risk and giving investors the benefit of the results of the management of its funds. Investment activities will then be divided into two categories: qualifying and non-qualifying. Whilst no minimum level of qualifying investment activity will be required, only qualifying activity will attract the benefits of the new regime.

Investment in shares, creditor relationships, and overseas real estate, as well as certain related investments in derivative contracts, will all be regarded as qualifying. All other investment activities will be non-qualifying; this category will notably include investment in UK real estate and any trading activity which the AHC carries on whilst still meeting the "substantially all" test.

Interestingly, the response paper acknowledges the uncertainty which can arise in the UK in distinguishing between trading and investment activity and contemplates a new test of investment activity to offer greater certainty than existing law. However, no further details have yet been provided.

— Other considerations. The government is still considering the potential for the rules to require (as part of the eligibility criteria) a minimum amount of capital raised by an AHC for investment. The potential range quoted in the response paper is £50m to £100m, which would include debt funding. Listed companies will be prevented from becoming QAHCs, and companies must also choose between the REIT and QAHC regimes, if eligible for both.

Taxation of a QAHC

The government intends that QAHCs should be taxed based on a modified version of the standard corporation tax rules. The modifications are aimed at ensuring that, in broad terms, most income and gains can be returned to investors without significant UK tax being paid on those amounts by the QAHC. The underlying principle is that the UK tax paid by the QAHC should be proportionate to the intermediate role it performs in the fund structure.

Specific elements mentioned in the response paper include:

— Loan relationships. Certain elements of the existing rules will need to be adjusted or switched off to achieve taxation of the QAHC based on its commercial margin, adjusted under transfer pricing rules where necessary and measured on an accruals basis. This means, for example, that rules which treat payments on profit-participating and results-dependent loans as (non-deductible) distributions will be modified to allow the QAHC a deduction for those amounts. Corresponding changes will be needed so that UK tax-paying recipients of those amounts are subject to tax on receipt.

— Chargeable gains. Whilst consideration was given to a wide-ranging exemption for all chargeable gains made by a QAHC, the government ultimately intends to proceed with a targeted exemption applicable to gains on disposals of shares (other than shares deriving at least 75% of their value from UK land) and interests in such shares, and gains on disposals of overseas real estate. Losses generated on the disposal of such assets will not be allowable. Although the scope of related anti-avoidance rules has not yet been decided, this new exemption would appear to address the various shortcomings associated with the existing "substantial shareholding exemption" from gains on disposals of shares and interests in shares.

— Ring-fencing. Ring-fencing rules have been proposed, to separate qualifying activities (and their associated profits and losses) from non-qualifying activities. These will effectively deem a QAHC to be two separate entities, with assets and transactions apportioned between them. The notional entity carrying on the qualifying activities will be subject to the modified corporation tax rules for QAHCs, whereas the notional entity carrying on non-qualifying activities will be subject to the regular, unmodified corporation tax rules.

— Entry to and exit from the regime. Existing companies will be able to elect to become QAHCs. A newly-elected QAHC will be treated as disposing of and re-acquiring the assets relating to its qualifying activities on entry into the regime, rebasing them to market value and triggering any latent gain (subject to the availability of losses, reliefs and exemptions). Similarly, assets relating to qualifying activities would be rebased on exit from the QAHC regime. The treatment of QAHC losses, and the effect of temporary breaches of the eligibility criteria, are still under consideration.

Other considerations

— Withholding tax. The UK has a general 20% withholding tax on payments of yearly interest. Although there is often relief or exemption available (for example, under double tax treaties, or under the so-called "quoted Eurobond" exemption), access can be burdensome. The government is therefore proposing to switch off the withholding obligation for payments of interest in respect of securities held by investors in a QAHC.

— Gains in the hands of investors. An intention of the new regime is that gains realised by the QAHC and passed up to individual UK-resident investors should be treated as capital in the hands of those investors. To achieve this, the proposed legislation will switch off rules that would otherwise treat certain amounts payable on the repurchase by a company of its own shares as an income distribution.

— Stamp taxes. The government has rejected the idea of a blanket stamp tax exemption for the transfer of shares or other securities issued by a QAHC. This is on the basis of the potential Exchequer impact (it being anticipated, for example, that in private equity exit transactions the companies most likely to be sold would generally qualify for QAHC status). An exception is the circumstance where a QAHC repurchases its own shares or debt securities, for which some form of exemption is anticipated.

— Anti-avoidance rules. The response paper suggests that targeted anti-avoidance rules may be considered necessary to protect the new regime from abuse. The format and nature of any such rules is still under consideration.

What are the next steps?

The government will now re-engage with stakeholders to close out open items (including some not mentioned in this bulletin) and fine tune the drafting of the legislation for inclusion in the next Finance Bill.

Related links

For more background information, our bulletin on the initial consultation and the government's response to it is available here.

The HM Treasury response paper is available here, and the draft legislation (and accompanying documents) are available here.

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