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CLIENT ALERT

New UK Asset Holding Company Regime: An Update

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The UK government has published final draft legislation for the new qualifying asset holding company (**QAHC**) tax regime, which is due to come into effect from 1 April 2022. Discussions are also ongoing with HM Revenue and Customs (**HMRC**) about detailed and operational aspects of the regime, and formal guidance is expected before April.

Initial draft legislation on key aspects of the regime was published in July 2021 (our previous client alert on the initial draft is available here). There have been several important, mostly welcome, changes to the key eligibility criteria and the tax advantages available to QAHCs since this first iteration, including:

- the exemption from withholding tax on interest has been extended to all payments by a QAHC, not just those to its investors;
- added ability to obtain interest deductions on convertible debt;
- broader diversity of ownership criteria for qualifying funds;
- relaxation of the activity condition to permit single-asset holding companies;
- new provisions allowing non-domiciled investment managers to benefit from the remittance basis on non-UK source income and gains; and
- inclusion of entry/exit and administrative provisions.

Background/Recap

The new QAHC regime is one of the first proposals to be taken forward as part of the UK government's review of the UK funds regime, announced in the Chancellor's 2020 Budget. It is specifically intended to enhance the UK's competitiveness as a location for asset management and investment funds, in order to better compete with other established asset-holding jurisdictions (such as Luxembourg and Ireland) commonly used by asset managers. It is hoped that the new QAHC regime will, as a result, help bolster the UK funds industry more generally by enabling greater co-location of fund activities in the UK (where managers may already be based and/or can take advantage of the wealth of existing supporting infrastructure). For asset holding vehicles which meet the eligibility criteria and elect into the regime, a range of generous tax advantages are available which aim to minimise any tax leakage suffered as a result of the imposition of a corporate investment platform.

The introduction of the QAHC regime follows two rounds of consultation on its design. Draft legislation for inclusion in Finance Bill 2022 was published in July 2021, which has since been amended following consultation and subsequently at the Committee and Report stages of the Bill's passage through the House of Commons. The final draft of the legislation was published earlier this month and is expected to be enacted within the next few weeks once the Bill completes its passage through Parliament. Guidance from HMRC is also expected before the regime comes into effect in April.

Eligibility

An asset holding company (**AHC**) will only be able to take advantage of the new regime if it meets the following eligibility criteria:

- *UK tax residency*. The AHC must be resident for tax purposes in the UK. It is not necessary, however, that the company be UK incorporated. It will therefore be possible, for example, to use a Jersey incorporated/UK resident company within the QAHC regime; indeed, this option may be beneficial in some cases in overcoming remaining stamp duty and corporate law issues (discussed further below).

- *Ownership condition*. Relevant interests held by non-"Category A investors" in the AHC must not exceed 30%. This condition is described in more detail below.

- *Activity condition*. The main activity of the AHC must be carrying on an investment business. Any other activities (i.e. trading activities) must be ancillary to that investment business and not carried on to a substantial extent. This condition should not be an issue for most private equity funds or credit funds which acquire debt on the secondary market for investment purposes. It is less clear how this condition will affect funds which engage in loan origination activities. We consider that, where such origination is carried on with the intention of creating loans which will be held for investment purposes, there is a good argument that this condition should be met, but it is hoped HMRC guidance will provide some clarity on this point.

- *Investment strategy condition*. The investment strategy of the AHC must not involve the acquisition of equity securities that are publicly listed or traded, except for the purpose of facilitating a change of control. Despite the general prohibition, this does allow the acquisition of an initial shareholding in the context of a public-to-private transaction. Further, this condition should not affect a potential IPO exit strategy which may involve a "lock-up" period, as that exit would not involve the *acquisition* of public securities by the AHC.
- *Public securities*. No equity securities of the AHC may be listed or traded on a public market or exchange.
- *REIT*. The AHC must not be a UK Real Estate Investment Trust.
- *Election*. The application of the QAHC regime is not automatic; the AHC must elect into it. Both newly established and existing AHCs may elect into the QAHC regime. There are transitional provisions for existing AHCs entering the regime, including a deemed disposal and reacquisition of its assets prior to entry (although the resulting tax charge may be mitigated by an extended substantial shareholdings exemption).

Ownership condition

The ownership condition is likely to be the most difficult condition for asset and investment managers to have to consider. The basic condition requires that relevant interests in an AHC held by non-"Category A investors" must not exceed 30%. The inverse, that "Category A investors" must hold 70% of relevant interests, while perhaps a useful shorthand is not strictly correct because, as will be seen, the calculation required by the legislation can result in all relevant interests adding up to more than 100%.

A person has a relevant interest in an AHC if, as a result of holding ordinary shares or loans (other than normal commercial loans), they hold:

(a) a beneficial entitlement to a proportion of the company's profits available for distribution to equity holders;

(b) a beneficial entitlement to a proportion of the company's assets available for distribution to its equity holders on a winding up; or

(c) a proportion of the voting power in the company.

Each investor's "relevant interest" for the purposes of applying the ownership condition is the highest of the three with regard to their individual holding. Therefore, where voting power does not follow strictly the economics for a company, such that different limbs of the test above are applied for different investors, the total of all relevant interests can sum to over 100%; care should therefore be taken in applying the 30% threshold.

In relation to carried interest arrangements in an AHC, it is the maximum beneficial entitlement that arises over the life of the arrangements (e.g. 20% in an 80/20 model) which applies in determining the carry holder's interests in the AHC; an increased entitlement that may arise under a "catch-up" is therefore disregarded.

Once each investor's relevant interest in the AHC has been determined, it is then necessary to classify each investor as a "Category A investor", or not a "Category A investor". Under the QAHC regime, the following are "Category A investors":

- Qualifying funds;
- Qualifying investors: UK or overseas pension schemes, certain UK or overseas authorised life insurance companies, UK REITs (and non-UK equivalents), entities benefitting from sovereign immunity, and most UK and EU charities;
- Certain UK public authorities;
- QAHCs; and
- Intermediate companies (essentially a wholly owned investment vehicle of one or more other "Category A investors", other than a QAHC).

For some investment managers, the application of these rules may be straightforward. However, for managers dealing with investment funds of varying types, the concept of "qualifying funds" is likely to add further complexity. A fund (being a collective investment scheme (**CIS**) or alternative investment fund (**AIF**), the definitions of which are taken from regulatory legislation) will be a qualifying fund if it falls within at least one of three criteria:

- It is a CIS that meets the genuine diversity of ownership (**GDO**) condition. The GDO condition is borrowed from the UK's Offshore Funds legislation and essentially requires interests in the fund to be marketed and made available widely and contain no terms which effectively limit investors to a specific group or deters other investors from investing.
- It is a CIS or AIF which is "not close". A fund will be close if it is controlled or majority economically owned by five or fewer participators (e.g. partners in a partnership, shareholders of a company) and their associates. For these purposes only, partners in a partnership are not associates of one another.
- It is a CIS or AIF which is 70% controlled by "Category A investors". A similar test based on entitlement to income, assets and voting power applies as for relevant interests in the QAHC.

A QAHC must take reasonable steps to monitor whether the ownership condition is met over the life of the structure. It will therefore be important for managers to have accurate information about their investor base both at the time of the initial investment and as investors leave and enter funds. For funds which may find the QAHC regime beneficial, it may therefore be helpful to ensure subscription agreements and initial investor due diligence forms collect appropriate information to be able to easily assess their "Category A" status, make the most appropriate structuring decisions and to closely monitor the nature of investors entering their funds (for example on secondary sales of fund interests). However, this process is likely to be much easier where funds can rely on the GDO condition, which does not require a detailed review of investor status.

Finally, it is worth noting that there is a two-year "ramp-up" period available in which the AHC can meet the ownership condition (provided that there is a reasonable expectation that it will be met), which will be helpful for funds making investments during their fundraising period.

Tax Advantages

A QAHC which has made it through the eligibility criteria and elected into the regime will benefit from generous tax advantages, including:

- *Exemption from corporation tax on capital gains* on disposals of shares (other than in "UK property rich" companies) and overseas land.
- *Exemption from corporation tax on profits* from an overseas property business where those profits are subject to tax in an overseas jurisdiction.
- *Exemption from UK withholding tax on interest* payments by the QAHC. This is more generous than initially envisaged; the initial draft of the QAHC legislation only provided an exemption from withholding tax on interest payments to *investors* in the QAHC.
- *Deductibility of certain interest payments* that would otherwise be disallowed (e.g. interest paid on profit participating loans or convertible securities, and on late paid interest).
- *Capital treatment on buybacks of shares* by the QAHC. This is in place of income treatment which generally applies for UK individuals, which attracts tax at the higher income tax, rather than capital gains, rates. However, this capital treatment does not apply to shares held by portfolio company executives (it does apply to fund executives). Careful thought should therefore continue to be given to where portfolio management holds shares in an investment structure.
- *Exemption from stamp duty* and Stamp Duty Reserve Tax on the repurchase by a QAHC of its own shares and loan capital. Importantly, however, there is no exemption on transfers of shares in the QAHC. It may therefore be

beneficial to incorporate a QAHC in a jurisdiction which does not impose stamp duty, such as Jersey, to further mitigate potential stamp duty charges.

- *Special rules for non-UK domiciled investment managers* who use the remittance basis, to benefit from the remittance basis regime for non-UK source income and gains from the QAHC.

Other Issues

While the tax advantages of the QAHC regime undoubtedly go some way in enhancing the attractiveness of the UK, certain issues remain which should be considered in deciding whether a UK QAHC is the right structuring option for particular investments:

- *Corporate law considerations.* While the rules above facilitate the buyback of shares from a tax perspective, for UK-incorporated QAHCs, corporate law considerations will remain an important factor in being able to carry out such transactions. In particular, the Companies Act 2006 generally requires the company to have sufficient distributable reserves and for strict processes to be followed. This could be addressed, however, by incorporating the QAHC in a jurisdiction with a more flexible corporate law regime, such as Jersey.

- *Ring-fencing.* The QAHC will be "ring-fenced" from other group companies for corporation tax purposes. This means the QAHC cannot surrender losses to non-QAHC group companies (and vice versa) and it is not possible to carry out a tax-neutral intra-group transfer of assets from a QAHC to a non-QAHC. This point will be particularly important when structuring investments and modelling financial returns from an investment, particularly with respect to debt financing.

- *Transfer pricing.* The UK's transfer pricing rules will apply to the QAHC, with the SME exemption disapplied and all investors (regardless of size) treated as meeting the participation requirement. Investment managers should therefore consider carefully the terms of all transactions between the QAHC, its investors and its portfolio companies from a transfer pricing perspective, and take specialist advice where appropriate.

- *Reporting requirements.* A QAHC will be subject to enhanced reporting requirements to HMRC. In particular, it will be required to provide certain additional financial information with its tax return, including the market value of its assets.

Final Thoughts

As we previously noted on the publication of the initial draft legislation, the new QAHC regime is a welcome step in bolstering the attractiveness of the UK as an asset holding jurisdiction, and the changes made since then have further helped to support this. Overall, we consider that the advantages provided by the QAHC regime not only place the UK on a level footing with jurisdictions such as Luxembourg or Ireland, but in fact have the potential to make a UK investment holding platform even more attractive. In many cases, a UK holding platform will reflect the reality of where substantial activities within the manager group and fund are carried out, helping to address substance-related questions, which have been of increasing importance in recent years. In addition, a UK company will be outside the scope of the EU's proposed ATAD III rules (concerning the treatment of shell companies), and will benefit from the availability of the extensive supporting infrastructure for funds in the UK.

We now look forward to the publication of HMRC guidance before the regime comes into effect from 1 April 2022, which it is hoped will help to address some of the remaining practical and interpretive aspects of the regime.

More broadly, the UK government's funds review remains ongoing, which we hope will further enhance the UK's competitiveness as a place for investment funds to set up and operate. In particular, a consultation on options to simplify the VAT treatment of fund management fees is expected (hopefully) soon.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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