CLIENT ALERT

Guidance Published on New UK Asset Holding Company Regime

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HMRC, the UK tax authority, has this week published their eagerly awaited guidance (available here) on the UK's new qualifying asset holding company ("**QAHC**") regime. The guidance provides welcome detail on HMRC's view on certain key issues relating to the regime's eligibility criteria, but remains silent on certain other important points which we had hoped would be addressed.

The QAHC regime is one part of a wider review of the UK's funds regime. It is 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). In summary, the QAHC regime provides a range of tax benefits which aim to tax investors in QAHCs broadly as if they had invested in the underlying assets directly. Further detail on the key features of the QAHC regime can be found in our previous client alert (available here).

What does the guidance say?

Some of the most interesting points covered by the guidance regarding the eligibility criteria are summarised below.

Monitoring the ownership condition

A QAHC must take "reasonable steps" to monitor, on an ongoing basis, whether it continues to meet the ownership condition necessary to be eligible for the regime. Somewhat unsurprisingly, the guidance states that what steps are reasonable "should be a function of the overall level of risk, and the facts and circumstances" relevant to each individual QAHC.

The guidance does, however, go on to provide some useful insights as to what HMRC may consider reasonable in particular cases:

- A QAHC directly wholly owned by a fund which meets the genuine diversity of ownership ("**GDO**") condition would not need to carry out ongoing scrutiny of the qualifying status of its fund owner. This is because the question of whether a fund meets the GDO condition is a once-and-for-all determination. As such, the QAHC would only fail to meet the ownership condition in the future should another person acquire relevant interests in the QAHC's securities (at which time it would, clearly, need to determine that investor's status).

- For funds which do not meet the GDO condition, the level of scrutiny required will depend on the fund's composition. For example, for funds which comprise so many investors that their chance of becoming "close" is negligible, the scrutiny required could be minimal. On the other hand, where a fund is relying on either non-close status or 70% control by Category A investors and is near to breaching the relevant thresholds, a higher level of review will be required. In such cases the guidance suggests that the QAHC should seek confirmation of its investors' Category A status prior to undertaking any significant transactions (e.g. the sale of an investment which would be exempt under the QAHC regime, or a buyback of shares).

- Where QAHCs are owned (in whole or part) by intermediate companies, the guidance indicates that the QAHC should check their ownership structure regularly, which it suggests could be done annually as part of the QAHC's audit process.

More generally, the guidance also sets out certain measures which HMRC considers would be indicative of the QAHC taking "reasonable steps", absent any facts or circumstances suggesting a greater level of scrutiny is appropriate:

- Provisions in the QAHC's articles of association (or equivalent constitutional documents for non-UK incorporated QAHCs) obliging shareholders to notify the QAHC should their Category A status change.

- Obtaining, as part of the process for registering a transfer or issue of securities, written confirmation from incoming investors of their Category A status.

- Maintenance by the QAHC of a record of the total relevant interests held in it by non-Category A investors.

- A verification process in relation to the registration of any transfer or issue of securities giving rise to relevant interests, enabling the QAHC to request and be provided with information from investors to enable the QAHC to assess its satisfaction of the ownership requirement.

Activity condition – ancillary activities

The activities of a QAHC must be the carrying on of an investment business (see below as to the meaning of investment versus trading); any other activities of the QAHC must be (a) ancillary to that investment business and (b) not carried on to any substantial extent. The QAHC legislation does not provide any further detail as to what will be considered "ancillary" or "substantial", and so it is left to the guidance to shed light on how HMRC intends to interpret this provision.

As to whether an activity is "ancillary", the guidance helpfully indicates that the provision of intra-group management services to investee companies (as commonly done by holding companies in private equity structures) could be an example of acceptable ancillary activity.

On the second point, the guidance states that an activity will not, as a general rule, be considered to be carried on to a substantial extent if "the quantum of possible profit from the trading activities [is] sufficiently limited that no potential investor in the company [would] be expected to have regard to it in deciding whether or not to invest". Further, in assessing whether an activity is substantial, the fact that an entity paying the trading income to the QAHC may be a subsidiary, such that the consolidated impact of the activity is nil, would be ignored.

Overall, this is a fairly strict test (stricter than was widely anticipated), and is likely to provide only marginal scope for a QAHC to carry on non-investment activities. In particular, both the two-limb test itself (ancillary *and* not substantial) and HMRC's interpretation of substantial in this context, is much narrower than the 20% test adopted by HMRC for similar tests concerning the substantial shareholdings exemption and business asset disposal relief that some commentators had predicted would also be applied in this context. That said, it should be borne in mind that the guidance only sets out HMRC's interpretation of the legislation and is not itself the law–but, while it will take a brave manager to deliberately challenge HMRC's view in the courts by carrying out more extensive trading activities, we anticipate that the extent of trading activities in a typical private equity fund structure should not cause an issue in any event.

Investment strategy condition – listed securities

The investment strategy of a QAHC must not involve the acquisition of equity securities that are listed or traded on a public market or exchange, other than for the purpose of facilitating a change of control. The guidance provides helpful reassurance on several practical aspects of this condition:

- The carve-out to the investment strategy condition allows stake-building in anticipation of a public-to-private takeover bid. Where such bid is unsuccessful, the condition does not strictly require divestment of the acquired stake; all that is required is that the shares of a public company were not *acquired* as part of a strategy to hold listed securities, other than for the purpose of facilitating a takeover. While the guidance acknowledges that, in practice, the failed bidder would generally be expected to divest itself of the stake, this does provide comfort that

if such shares are nevertheless held for some period (for example, if the QAHC were to sell down its stake over the course of a few months), this will not breach the investment strategy condition.

- In addition, the condition does not prevent an exit from an investment by way of an IPO involving a lock-up period for the same reason (i.e. because this is not part of a strategy of *acquiring* listed shares). Further, the guidance also helpfully makes clear that even where the IPO process involves the (common) step of acquiring new shares, such as in a new holding company, this will not disqualify the QAHC.
- Similarly, where a QAHC acquires unlisted shares in a company which subsequently lists, but where the QAHC's stake is small enough that it is not closely involved with planning such listing, it should not be in breach of the investment strategy condition.

Two-year "ramp-up" period

A company has the option of entering the QAHC regime before it meets the ownership criteria and taking advantage of a two-year grace period to do so. This grace period will be helpful, for example, to private equity funds which start to make their first investments early in their fundraising period, when they may not yet meet the definition of qualifying fund and therefore not be a Category A investor. In order to utilise this grace period, the company must have a "reasonable expectation" that the ownership condition will be met within two years of it entering the QAHC regime.

The guidance states that in order for there to be such a "reasonable expectation", there must be a "clear path" to meeting the ownership condition within the two-year period. This may involve, for example, the company or its sponsors having commenced negotiations with Category A investors, or a fund manager having a pool of regular Category A investors with whom they have a relationship and so might expect to invest. However, the guidance states that it is not sufficient that the company or others have merely approached a number of potential Category A investors with a "vague hope" that they will come on board to meet the ownership condition. In light of this, we would recommend that managers looking to make use of the grace period keep clear records of their discussions with prospective investors to substantiate their expectation of investment.

The guidance also provides an indication of some of the cases in which HMRC may agree an extension to the two-year grace period. This may be where negotiations are ongoing with a potential major Category A investor (whose investment will result in the ownership condition being met) and the deadline for such negotiations has been set for a short period (i.e. three months) after the end of the two-year period.

What doesn't the guidance say?

There are a few areas of the QAHC regime on which we were hoping for guidance from HMRC which are not covered by that published this week. This includes:

- *Investment versus trading*. As noted above, the activity of a QAHC must be the carrying on of an investment business, and any other activities (i.e. trading) of the company must be ancillary and not substantial. For many QAHCs, determining whether its activities are in the nature of investment or trading will be straightforward, particularly for those utilised by private equity funds. However, for others, the position will be less clear and will require a close analysis of the (intended) activities of the company.

  It was hoped that the guidance would help shed some light on what will be considered investment and trade for the purpose of the QAHC regime, there being no definition in the legislation itself for this purpose. Instead, it merely refers to HMRC's existing guidance on the meaning of trade, which will be far from definitive in respect of certain strategies pursued by QAHCs (in particular in relation to loan origination activities).

- *Parallel funds*. The legislation requires the status of each fund entity investing in a QAHC to be assessed individually. However, this does not reflect the reality of the private funds world, where a "fund" is often made up of several parallel and/or feeder entities which are marketed and operate effectively as a single investment fund. It was hoped that the guidance would provide some helpful commentary on how to deal with such arrangements, particularly when considering the GDO limb of the qualifying fund definition, but it is unfortunately silent on this point.

Final thoughts

As we have remarked above, the guidance published this week provides useful insights as to how HMRC will approach some of the key issues around the eligibility criteria for the QAHC regime in practice. There remain several areas on which additional guidance would be welcome, but as the first public iteration of guidance on a wholly new regime, this is to be expected. We hope and expect that HMRC will continue to review and update its guidance to reflect issues which arise as funds start to make use of the QAHC regime from 1 April 2022.

For funds wishing to utilise the regime in the meantime, we note that HMRC have indicated that their QAHC team will be open to discussing particular eligibility questions. The fact that HMRC have established a dedicated QAHC team that can be contacted directly by email or telephone (as opposed to, for instance, needing to route questions via a general corporation tax helpline or a business's customer compliance manager) is a very welcome measure in facilitating an efficient use of the QAHC regime in practice.

We expect that such contact with HMRC's QAHC team should enable investment managers (and their advisers) to obtain answers to specific questions about the eligibility of their (proposed) structure for the QAHC regime without going through the time-intensive, and more costly, process of obtaining a formal clearance.

Nevertheless, in marginal cases, investment managers may still wish to consider submitting an application for formal clearance, which will be dealt with by the QAHC team. The processing of such applications by officers with specific knowledge and experience of the QAHC regime should, we hope, be helpful in obtaining timely–and useful–clearance responses from HMRC.

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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