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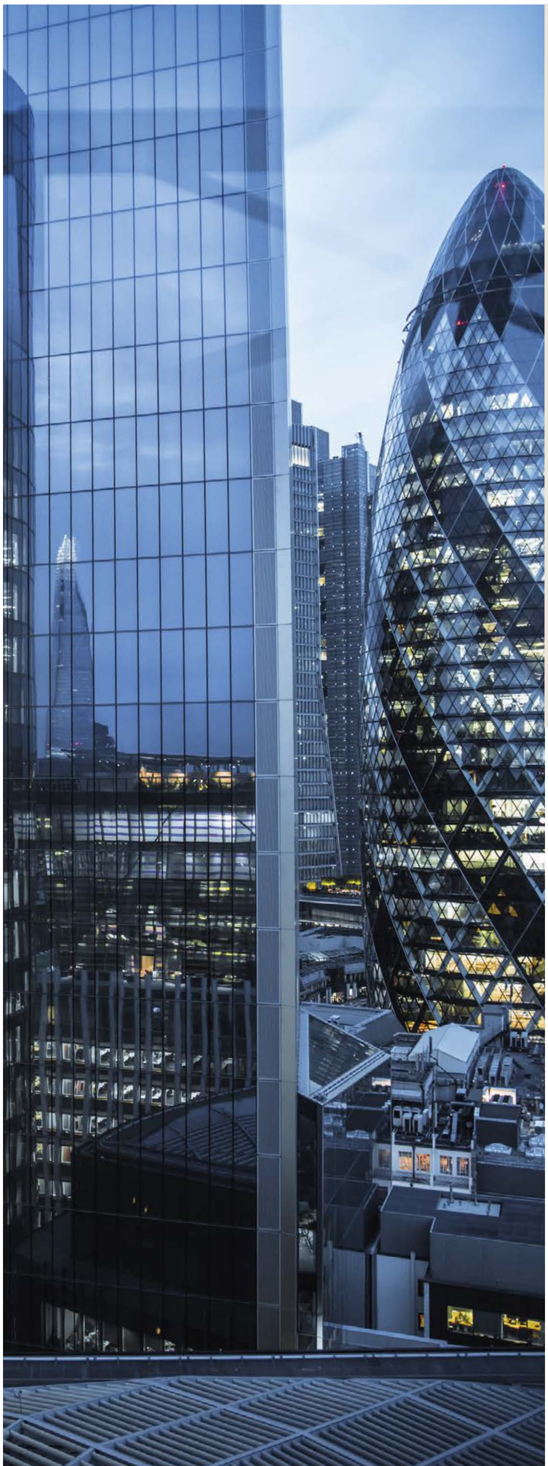

UK asset holding company proposals

A truly competitive regime?

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Analysis

The UK asset holding company regime: what's proposed

Speed read

The proposals for a new UK asset holding company (AHC) regime, to be introduced next year, are welcome and exciting. The tax benefits are generous, with eligible AHCs, broadly, being exempt from gains tax, taxed on a small profit margin on income and able to return capital gains to investors as capital. The position for real estate funds may need to differ slightly, reflecting the need for UK real estate profits and gains to remain taxable, but more flexible rules for REITs are anticipated. To ensure success, i.e. to be internationally competitive, it is vital that the rules are simple to understand and operate.

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In December, HM Treasury (HMT) published a consultation document (the condoc, see bit.ly/3bOh4FH) with high-level proposals for a new, tax-privileged regime for asset holding companies (AHCs) in alternative fund structures. This is part of the government's review of the UK funds industry (as announced in the March 2020 Budget) and follows on from a consultation last year that assessed the case for reform of the UK's tax treatment of AHCs.

Although the proposals leave many points open for discussion, they are a highly positive step, envisaging an attractive UK regime, coming into force as early as next year, where AHCs suffer very little direct tax leakage, being exempt from tax on gains and taxed only on a very low profit margin on income, and are able to return capital gains to investors as capital.

The government's aim is to offer a highly competitive structure for AHCs in the UK, with all the attendant benefits that would bring for the funds industry and UK economy – which is all good. For it to succeed, however, clarity and operational simplicity are key (vital even, given investors' increasing familiarity with offshore structures). Importantly, HMT (which, interestingly, is leading the consultation) recognises this and is actively seeking industry engagement on the optimal solution.

Problems with the current UK rules

A key principle of fund structuring is that investors should not be in a worse tax position as a result of investing through a fund than if they had invested directly in the underlying asset. To be effective, this tax neutrality should extend beyond the fund vehicle to the plumbing underneath, i.e. the various holding (typically opaque) entities that it is likely to use to hold investments.

Whilst the UK does not currently have a standalone regime for AHCs, one might think that it should already be an attractive location: the substantial shareholding exemption (SSE) may shelter gains on disposals of trading companies, dividends received should generally benefit from a wide exemption from corporation tax, no withholding tax (WHT) should generally apply to dividends paid and it should be possible to structure loan arrangements such that interest can also be paid free of UK WHT. However, although in some circumstances the UK's patchwork of available reliefs will, indeed, provide a full solution for a fund (the UK is commonly used as an AHC location for domestic private equity funds), it will often (for example, frequently in the case of credit funds) result in significant tax leakage. In addition to this, it is complex to understand and often difficult to apply. Issues include:

- difficulties in matching taxable income with deductible expense, increasing tax leakage;
- complexity in applying the SSE, plus a lack of certainty, at the outset, that it will ultimately apply at the relevant point in the future;
- difficulties under both UK tax and company law in extracting a return from the AHC that is treated as capital for tax purposes, even when the underlying profit was itself capital; and
- administrative hassle and the costs arising from listing notes to benefit from the quoted Eurobond exemption from UK WHT on interest.

As fund houses are increasingly allocating greater resource to satisfying local 'substance' requirements, there is a tendency for them to locate fund vehicles in the same jurisdiction as AHCs and vice versa. Therefore, a jurisdiction that can scoop AHCs is increasingly likely to attract fund vehicles too, with the attendant business that generates.

The current consultation

As reform of the UK tax treatment of AHCs is part of a wider review of the UK funds regime, it seems that those respondents to last year's consultation calling for such reform were pushing at an open door. As well as dealing with AHCs, the proposals contain some targeted, helpful reforms to the UK REIT regime that aim to facilitate its use as an asset holding regime and joint venture vehicle.

The AHC consultation will not, however, address the VAT position, which we expect to be picked up, separately, as part of the upcoming review of VAT on fund management fees. HMT appreciate that company law may be relevant, but this is not covered by the review and it is not entirely clear how it will be addressed.

The timetable for all this is fairly tight. The consultation ends on 23 February 2021. Helpfully, however, HMT has said that it would be very happy to take comments and have discussions before then in order to have as much time as possible to digest and work through points raised. Our understanding is that draft legislation will be published in the summer, with a view to enactment in 2022.

The proposals: eligibility criteria

The government sees these structures as needing to be safe from abuse, so it is not intended that they should be open to everyone. The condoc (para 4.9) explains that the government 'believes that the rationale for bespoke rules for AHCs is clearest in structures where capital from diverse or institutional investors is pooled and managed by an independent, regulated or authorised asset manager, in which the AHC plays an intermediate, facilitative role.'

Accordingly, it envisages eligibility criteria focusing on (i) investors (in effect, the owners of the AHC); (ii) management; and (iii) the character and activities of the AHC.

Criteria for investors

The intention is, essentially, that the rules should not apply in relation to funds or companies controlled by a small number of persons. This concern is a common one in the UK tax code, especially in the context of investment funds. Helpfully, HMT has said that it intends to use familiar concepts. The concern here is familiar to whom? It should not just be those familiar with the twists and turns of UK tax law.

The condoc sets out two possible alternative approaches. The first would require that an AHC be wholly owned by a fund or number of funds that are each either a collective investment scheme (CIS) or an alternative investment fund (AIF). In addition, HMT is seeking views as to whether to include REITs and their overseas equivalents. This must be right in the context of real estate. As this will not, however, necessarily ensure that the fund is not controlled by a small number of (non-institutional) investors, the condoc says that the regime could also require that the fund vehicle either:

- meet the 'non-closeness' or the genuine diversity of ownership test (GDO); or
- be unable to meet either of those tests only because it has one or more 'qualifying investors' (perhaps using a similar definition to that in the non-resident CGT rules (NRCGT)).

As the relevant fund may be a limited partnership, it may be that HMT envisages the 'non-closeness' test applying to the AHC rather than, as set out in the condoc, the fund vehicle. This would be in line with the exemption rules in the NRCGT code. The scope of the non-closeness test will be particularly important as, in practice, many alternative funds may not meet the GDO.

An eligibility criteria that requires ownership exclusively by funds would, however, exclude AHCs owned by a single institutional investor and situations where pooling occurs at the level of direct investment in the AHC (e.g. where management co-invest at AHC level, rather than through the fund). The condoc, correctly, sees this as potentially problematic and, therefore, suggests a second, alternative, route, whereby the regime looks directly at investors' interests in the AHC itself to determine whether it was set up to benefit diverse or institutional investors (rather than requiring that the AHC be owned by a fund set up for that purpose). The condoc says that this alternative route might mean that a company could only qualify as an AHC if it is 'non-close' (or is only close because it had one or more owners who was within a category of permitted investor, such as a qualifying investor).

Where we end up on this issue will be critical to the regime's success. The first route, as currently suggested, should be avoided for the reasons discussed above. The second route looks more promising, but, if followed, should (as in the NRCGT rules) allow tiers of investors to be looked through when assessing whether an owner is a qualifying investor and some new criteria are likely to be needed as to who exactly is a qualifying investor here. Surprisingly, HMT appears to be considering not allowing a look through of intermediate holding entities when ascertaining investors. Such an approach would prevent common benign situations falling within the regime (e.g. where there is a chain of AHCs or an institutional investor invests via a wholly owned holding company). However, it is anticipated that this will be ironed out along similar lines to the NRCGT rules, as, HMT appears, from discussions, to accept that there can be tiers of AHCs. Simpler still, rather than constantly refer to UK tax concepts in what is intended to be a widely understood international regime, the rules could also include, as part of the criteria, a list of acceptable investors, such as pension funds.

The condoc also discusses how the regime should identify an 'investor' and says that the government anticipates, broadly, that this will be a person who has an interest in and participates in the results of investment assets that the AHC acquires, such that lenders who advance fixed rate loans would not be included, whereas those who advance ones with a results dependent interest rate would be.

Criteria for management

HMT proposes that an AHC should sit within an investment structure that uses an independent asset manager who provides investment management services, including managing fund assets, in return for an investment management fee.

The proposals, therefore, consider how to identify what constitutes a manager (e.g. is it the person that contracts to perform portfolio and/or risk management with regard to the AHC's assets?) and what requirements that person must meet. On the latter point, HMT proposes that investment assets held by an AHC should be managed by an undertaking that is authorised or registered for the purpose of asset management, subject to supervision in their jurisdiction and independent of investors. HMT appears to recognise there should be an exception from the independence requirement for carried interest and management coinvestment, but intends that it be subject to a cap.

Care needs to be taken here that this includes structures such as internally managed funds and that it does not preclude those funds where the manager may be in fact a related entity to one of the investors, such as is commonly seen in the institutional space.

Criteria for the character and activities of the AHC

HMT wants to restrict the regime to entities that serve to facilitate flows of capital, income and gains between investors and investment assets.

Perhaps the key issue here is the extent to which this objective can be met without having a test based on whether (or the extent to which) the AHC is trading. This issue is fact specific and often gives rise to difficulties. In particular, the distinction between 'investment' and 'trading' does not expressly exist in all jurisdictions and, so, by adding an overlay of UK principles, would complicate a regime seeking to be flexible commercially and widely attractive. In addition, whether a company is trading is not something that is always known in advance, as it depends on what the company does in practice.

Although not expressly stated in the condoc, it seems that the government is aware of these concerns. However, it appears, at present, to be struggling to move away from a 'trading' test. Alternative solutions contain 'investment' requirements, but these would appear simply to be the other side of the same coin. A possible answer may be a 'white list' of transactions which will be deemed not to be trading. That solution was not proposed in the condoc although HMT are aware of it (being widely used elsewhere in the UK's tax rules for funds and mentioned in the condoc as something that respondents to last year's consultation had suggested). We understand that HMT consider that a white list would not suffice on its own and so further conditions would also be required. Where HMT lands on this issue will be important, indeed vital for some, with simplicity, again, being key on top of the need for commercial pragmatism. A similar concern to identify 'good' (i.e. non-trading) funds arose when the income-based carried interest rules were introduced, and complexity, similar to the average holding period rules found in that regime, should be avoided. Strong practical pushback with suggested solutions from industry is needed here.

HMT are also seeking views on further requirements to ensure that AHCs can only be used for their intended purpose, including that they have a policy or practice of reinvesting or returning capital to participants when investment assets are sold. This suggestion presumably relates to a concern that AHCs would be used as a mechanism by investors to roll-up gains free of tax. If the regime is to be simple to operate, this may be an area where the government does not legislate but, instead, relies on the typical commercial dynamics of a widely held externally managed fund that results in funds being returned as quickly as possible and a cash pile not being unnecessarily accumulated, simply to defer taxation at investor level.

The proposals for a qualifying AHC and its investors

Income profits

These will be taxable in the AHC but, crucially, such taxation should be proportionate to the AHC's role. HMT anticipates that, typically, this will be fairly limited (which, of course, in practice may not always be the case).

An issue here, is how the level of taxable profit can be managed to ensure that it is at the appropriate, proportionate level, potentially based on transfer pricing type principles. Helpfully, HMT is considering allowing deductions for profit-dependent interest, but it is also looking at wider ideas, so that the desired result can be achieved without being tied to a particular sort of instrument, whilst ensuring that profits are not reduced below the proportionate level.

HMT recognise that the special rules for AHCs could potentially be subject to the hybrid mismatches rules. Helpfully, the condoc confirms that it is intended that they will be disapplied, to the extent needed to meet the policy objectives of the AHC regime.

Capital gains

AHCs will have a new relief for gains on disposals of investment assets, such that there should be no tax on gains generally at AHC level. Non-UK investors should receive such gains free of UK tax, as at present. The potential exceptions to the relief are UK land and assets that derive 75% or more of their value from UK land (UK property rich assets) (considered further below).

HMT anticipates that gains that are not reinvested will be taxed when returned to UK investors (or on those investors when they dispose of their interest in the AHC). Here, their concern, focused on UK investors, is of AHCs being used to artificially roll up gains. It is important that how this is dealt with does not constrain the operational benefits of an AHC structure.

Withholding tax on payment of interest to investors

HMT is considering introducing an exemption from WHT on interest for loans from investors to AHCs. While, in practice, funds can often obtain relief or exemption from UK WHT, the lack of cost and administrative hassle resulting from a bespoke exemption would generally be welcome.

HMT are considering whether anti-avoidance provisions need to be built into the exemption to prevent misuse. However, as it is currently possible to structure arrangements so that no WHT arises, it is hard to see what this would achieve.

Income and gains paid to investors

Under the proposals, amounts deducted from taxable income of an AHC and paid to UK taxable investors would be treated as taxable income, whereas amounts returned to such investors that are attributable to capital gains realised by an AHC would be treated as gains in their hands.

Whilst variants of this income treatment already exist in the UK tax code (for example, deductible interest distributions paid by authorised bond funds), streaming underlying capital gains in the way proposed is more novel. This is a positive development in theory, as an effect of the current tax rules is that AHCs, can, in effect, convert an underlying capital return into income; a common reason why non-UK AHCs are used where income taxpaying investors are involved. An issue, however, will be how to keep this streaming mechanism simple, with a number of issues potentially requiring consideration, including how to match amounts received by the AHC for tax purposes (so potentially including accrued amounts) with returns it makes.

Unsurprisingly, this is an area where HMT has concerns about abuse, in particular schemes employing AHCs to convert income into capital for individuals. Perhaps once HMT has become comfortable about likely investors, it will be able to put some of these issues to rest and adopt simple principles. Given the wider international aims of the new AHC regime, it would be a shame for the simplicity of the regime at AHC level to be dictated by the taxation of UK individual investors.

Stamp duty and SDRT

HMT intends to explore providing a stamp duty exemption where an AHC repurchases its shares in order to return capital to investors. More generally, HMT is considering the case for broader exemption from stamp duty and SDRT on some or all transfers of shares and loan capital in an AHC.

Anti-avoidance

Views are, of course, being sought on possible ways in which the regime could be misused. These, for example, include amounts falling outside the scope of tax when the AHC exits the regime. It is, hopefully, not too much to propose that the government relies on tightly drafted rules which ensure that only intended arrangements fall within the regime, so that a single, principles-based TAAR would be the best solution. Whatever the outcome, it will be important that the regime does not include multiple, complex, bespoke anti-avoidance provisions, which render it either unworkable, unattractive or full of potential tripwires.

Reporting

Under the proposals, for a company to qualify as an AHC for an accounting period, it will need to make an election as part of its company tax return. As an additional element to that return, in order to enable the government to monitor the regime, AHCs will be required to provide specified information.

Other points

The condoc discusses a number of other tax areas aside from the above, including how the corporate interest restriction, controlled foreign companies and employment related securities rules could be relevant. Clearly, treaty access will be important for the AHC, should there be potential local withholding taxes, so this will need to be considered also in the final shape of the regime.

The proposals: real estate

Real estates and AHCs

It is key to the government that it retains taxing rights over income and gains derived from UK real estate. The principle is generally accepted by the industry, but raises issues that are not present with other assets classes. One potential approach, mooted in the condoc, is simply not to permit AHCs to hold UK land or UK property rich assets. This would be highly disappointing. Helpfully, however, HMT seems to be moving away from this, for example, at least allowing AHCs to hold UK real estate through a corporate vehicle. This would, however, only offer a partial answer, not achieving its goal for all investors, so we are likely to see some alternative thought on this one. Whether the solution is one that can alternatively or, indeed, optionally (given that it may not be an issue for all) be dealt with by some sort of streaming in the AHC remains to be seen.

The government seems to accept that the AHC itself should not be taxed on gains derived from non-UK real estate, which should be achievable through the general exemption from tax on gains realised by AHCs. That is good news. UK taxable investors would be taxable when the relevant funds were returned to them or they disposed of their interest.

Not so clear, however, is how an AHC's income from non-UK real estate it holds directly should be treated. Given that the income is likely to be subject to local tax, some have suggested that the AHC simply be exempt from UK tax altogether on such income. However, it appears that this is not HMT's preferred route, with concerns about access to treaty relief should a full exemption be given. It would prefer AHCs to rely on the existing rules giving relief for foreign tax paid. Nonetheless, HMT is happy to take more anecdotal evidence as to how this could work in practice.

Should HMT not move on this one, it is unclear how it envisages limiting the UK income taxation of an AHC by reference to the role it actually performs in this situation. Given the aim for a simple regime, we are expecting to see some strong representations here.

REIT reforms

In parallel with the new AHC regime, the government is also considering prioritising some targeted reforms to the UK REIT rules. The key proposals, which are the result of much discussion with the industry, are as follows:

- To widen the list of eligible institutional investors (relevant to meeting the non-close requirement). This is likely to follow more closely that used for the NRCGT rules but also to see an inclusion of widely held and look through rules for certain eligible institutional investors; this may, in fact, narrow the list for some from where it currently stands.
- To change the test for assessing whether a non-resident person is equivalent to a UK REIT. This is relevant as such a person is an eligible investor for the purposes of the non-close requirement. Currently, the test requires that person be equivalent to a UK REIT under an equivalent regime in that person's tax jurisdiction, but given all the different regimes, HMT is considering modifying this so that it suffices that the overseas entity would qualify as a UK REIT were it UK resident.
- The option of an unlisted REIT for certain investors. UK REITs listed on an exchange outside the UK have become increasingly popular amongst institutional investors, in particular, as a joint venture vehicle. Importantly, given the association of the REIT with the potential of liquidity through listing and access to a wider investor base in a closed-ended environment, the option of listing would remain. The new proposal is, therefore, only to apply to REITs whose investor base meets certain eligibility criteria. The introduction of further thresholds and potential cliff edges on top of the current regime requirements is likely to face pushback;
- Relaxation on the, effective, restriction on payments of dividends to corporate shareholders holding an interest of 10% or more in UK REITs, so that it only applies to those who are not entitled to gross payment. This will be good news for many UK corporate groups who, to date, have, in practice, generally had to disaggregate their interests amongst one or more subsidiaries to avoid breaching the threshold. Such a change should be of particular interest to UK life companies and some UK funds, for whom disaggregation is not usually an effective solution.
- A widening of the 75% balance of business test to offer more flexibility in compliance, given the need to cater for planning requirements and changes of circumstances. It is hoped that this could also encompass matters arising from the changing market and social and environment issues, potentially such as ESG demands, which could all be helpful.

A notable omission here is specific discussion of rules to facilitate and improve the position of UK REITs on non-UK investment. Given that this already happens in practice, we would expect to see this brought into the REITs workstream on the AHC, as a priority, to ensure it is on the same timescale as the other AHC changes. If not, it should be picked up as part of the more comprehensive review of the REIT regime as part of the wider funds review.

Where does this leave us?

The proposals are a very welcome development for the UK funds industry, with the government committed to introducing an attractive regime, and have real momentum (and need) behind them. The main challenge will be designing rules that are easy to understand and simple to apply in an international context. In particular, the eligibility criteria must be straightforward and certain; not laced with sub-conditions and caveats, such that fund managers would be unlikely to choose the UK over Luxembourg or other established competitor jurisdictions. Given, however, the resources that both the government and industry have already committed and continue to commit to this project, we are hopeful that this timely opportunity for positive change to support the UK's funds industry, at little cost to the exchequer, will be seized. ■

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- UK asset holding company consultation: the thick end of the wedge (A Howard, 1.4.20)