Taxation of UK asset holding companies in alternative fund structures

Draft legislation published 4 November 2021

On 4 November 2021 the UK Government published the full draft legislation on its new regime for the taxation of qualifying asset holding companies ("QAHCs"). The legislation is intended to have effect from April 2022. The legislation has been developed from the original draft legislation that was previously released in July 2021 and reflects much of the feedback received from industry stakeholders and during our working group sessions with HMRC and HMT.

The QAHC regime allows fund managers to align their investment holding vehicles or platforms with their UK economic substance. The QAHC will facilitate the flow of capital, income and gains between investors and underlying investments, so that it is expected that investors should be taxed broadly as if they invested directly in the underlying assets and the QAHCs pay no more tax than is proportionate to the activities they perform.

We expect this new regime to provide a credible option for the alternative investment industry to hold investments. However, in addition to the tax roadblocks being addressed in this new regime there are broader considerations such as commercial presence, corporate law and financial reporting requirements. Each fund manager will therefore need to evaluate if the regime is attractive for them.

We summarise in this publication:

- the key features and criteria to be eligible for the regime;
- other key considerations including when entering and exiting the regime; and
- the key changes since the draft legislation issued on 20 July 2021.

Key features of the regime

Disposals

- Gains on sale of "shares" are exempt, with no minimum holding period etc. Shares are broadly defined and include chargeable gains on derivatives which derive their value from shares. However, shares which derive > 75% of their value from UK property are excluded.
- Exempting gains on overseas property.
- Exempting profits of an overseas property business of a QAHC, where those profits are subject to tax in an overseas jurisdiction.

Withholding taxes

- There is no withholding tax on interest payments made by a QAHC. The UK already does not impose withholding tax on dividend payments anyway except for REITs (which can not access the regime).

Interest deductibility

- Interest and other finance costs on debt funding the QAHC, including profit participating and convertible debt, are in principle deductible on an accruals basis. These are generally able to match income arising on debt investments except for an arm's length margin. The finance costs may also offset other income but subject to various restrictions.

Returns to investors

- UK investors are able to obtain capital treatment on redemptions of shares at a gain (unless the shares are employment related securities).
- Buybacks, but not transfers, by a QAHC of shares and loan capital are exempt from UK Stamp Duty and Stamp Duty Reserve Tax.

Eligibility Criteria

In order for a QAHC to be eligible to enter the regime, it must be a UK tax resident company, however it need not be UK incorporated. The company must maintain compliance with three conditions: the ownership; the activity; and the investment conditions. Similarly, the company cannot be a UK REIT (which includes members of a group UK REIT) and none of the equity securities of the company can be listed or traded on a recognised stock exchange or any other public market or exchange.

An eligible UK resident company can have both a business within the QAHC ring-fence, and a business outside of the QAHC ring-fence, such as investment management or UK property rental businesses, which are taxed under ordinary principles.

Ownership condition

To be eligible for the regime, a UK resident must elect into the regime and it broadly requires the economic ownership to be at least 70% held by “Category A investors”, which include other QAHCs, qualifying funds (being either a collective investment scheme or an AIF that meets the diversity of ownership condition or is not “close”) or relevant qualifying investors (broadly including charities, pension schemes, sovereign investors, long term insurance businesses, UK REITs and overseas equivalents), or a public authority.

Category A Investors may also invest into a QAHC through an intermediate company that meets the activity condition and is at least 99% held by Category A investors. This can be UK or overseas tax resident.

Helpfully, the legislation includes a 2-year window for companies to meet the ‘ownership test’ as well as a 40 day “cure period” should a company breach the ownership condition.

Activity & Investment conditions

The activity condition requires the main activity of a QAHC must be connected with the “carrying on of an investment business”, and whilst a QAHC will be able to carry out other activities this cannot be a substantial activity of the company.

Linked to the above, the investment condition requires a QAHC’s strategy to not involve the acquisition of listed equity securities, except when looking to facilitate a change of control to take private.

Entry into the regime

A QAHC must make an entry notification to HMRC to state that the company intends to be a QAHC, and must include from what date the entity will become a QAHC (but this can be no earlier than 1 April 2022).

Converting existing companies to QAHCs

Whilst we expect most QAHCs to be newly formed entities, existing companies can convert to become QAHCs if they meet the conditions. Upon entry to the regime there will be a deemed disposal of any overseas land holdings, loan relationships relating to an overseas property business or any qualifying shares immediately before entry to the regime; and reacquisition immediately after entry.

Any gain on the deemed disposal is taxable, except gains arising on shares upon entry may be exempted where the conditions of the UK’s substantial shareholding exemption (“SSE”) apply. Helpfully, the regime allows for entities who have not yet held the qualifying shares for 12 months to apply SSE, provided that the QAHC will continue to hold those shares until the 12 month period is met.

Where entities migrate their tax residence to the UK, and elect into the regime within 30 days there will be no UK tax charge on the deemed disposal. There are also provisions to avoid double charges in certain specified circumstances.

Assets entering and leaving the (exempt) ring fence

Where an asset enters or exits the (exempt) ring fenced business, there is a deemed market value disposal (which will be taxable at the point the asset enters the ring fence business) subject to provisions intended to avoid double charges.

Exiting the regime

As with a company wishing to enter the regime, a QAHC wishing to leave the regime must make an exit notification. However, a QAHC will be treated as leaving the regime should it fail to meet any of the above eligibility conditions, and fail to cure any breaches.

The regime does however include a 2-year winding down period, allowing a company to continue to be a QAHC if it breaches the ownership condition due to the company being acquired by a non-qualifying investor or where its investor is a qualifying fund and it ceases to be a Category A investor.

Exit Charge

Similar to the Entry Charge, the company will need to notify HMRC that it is exiting the regime. Alongside this, the exiting of the regime would result in a deemed disposal and reacquisition of its qualifying assets (see the 'Entry Charge' section above) at market value. As the gain will arise under the QAHC regime, any gain should be exempted - resulting in a rebasing of those qualifying assets to their market value at that date.

Other points to note

By virtue of a QAHC being a UK tax resident entity, it will be subject to a number of ongoing tax and financial reporting requirements (some of which may only apply if the QAHC is also a UK incorporated company). These include: a requirement to publish its tax strategy, comply with senior accounting officer requirements and file financial statements with Companies House.

Tax losses arising in a QAHC ring fence may not be relieved against taxable profits arising in a non QAHC ring fenced business.

A QAHC will not have to apply hybrid instrument mismatch rules. However, with the aim of ensuring that the regime remains OECD compliant (as required under the EU withdrawal agreement), the rules relating to hybrid entities will still apply. These rules would therefore need to be considered, however the changes to the hybrid mismatch rules introduced from June 2021 may significantly mitigate the hybrid concerns in such structures.

The much discussed 'zero-rating' of management fees for VAT purposes has not been included in this draft. We expect this to be covered as part of the wider review of the UK funds regime.

Aside from the specific references to UK REITs above, and a provision to ensure that property income dividends received from a non-UK property rich REIT by a QAHC continue to be taxed as UK property rental income, the interaction between the QAHC and UK REIT regime is limited. However we expect that further changes will be announced in the future as part of the wider funds review.

Key changes since legislation released on 20 July 2021

For those that have been following the detail of the legislation, the Finance Bill draft has been amended since the July legislation with the following key changes:

- Inclusion of the entry/exit to regime requirements and implications;
- Ownership conditions allows for intermediate companies in certain cases and broadening of diversity of ownership criteria;
- Investment condition relaxed to allow for single asset holdcos, but with a new restriction to not have a strategy to own listed shares unless with the intention to take control;
- Requirements for minimum capital and independent management have been removed;
- Interest withholding tax relief extended to all payments instead of just shareholder loans (and similar);
- Ability to obtain deductions on convertible debt (in addition to profit participating debt), broadening the available instruments and helping to achieve capital treatment for UK investors;
- Disapplying hybrid financial instrument rules;
- Various changes to fix issues with matching income with expenses for debt investments, including in relation to foreign exchange; and
- Provision to allow non-domiciled asset management investors to continue to benefit from the remittance basis regime in relation to non UK source income/gains.

Final thoughts

We expect that the new regime will be broadly welcomed in the industry. The government has recognised and addressed most of the challenges that drive UK based investors to use overseas investment platform entities.

The QAHC is aimed at multiple industry sectors - Real Estate, Private Equity, Credit etc and many investor types. Whilst we are positive about the regime, we expect for many take up to be gradual and for this to appeal to some investors more than others.

Please reach out to us if you would like further information or assistance.