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UK asset holding company regime

Insights into the new regime

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UK asset holding company regime

In April 2022, the UK will introduce a new asset holding company (AHC) regime which will allow investment funds to base their under the fund investment holding structures in the UK, rather than Luxembourg or Ireland.

The regime is designed to take the existing features of the Luxembourg regime and improve on that regime in several ways. The crucial advantage of the regime compared with the Luxembourg regime is that it will be capable of being operated wholly from the UK. This will mean it will be cheaper and operationally easier to establish the necessary substance.

Now that the UK has published its draft legislation (in fairly final form, although we hope for further improvements before it becomes law) the operating framework governing the regime is now apparent. We have been heavily involved in developing the UK AHC regime from inception (our initial discussions with HM Treasury around the idea date back to 2018) through the consultation process and to the development of the draft legislation.

> This brochure provides a detailed walk-through of the draft legislation (updated for latest amendments to the draft legislation following the Public Bill Committee stage) and its application to typical structures in a private equity and credit fund context. It does not seek to cover real estate aspects and parts of the regime focussed on those aspects are excluded.

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Conditions for entry into UK AHC regime

The UK AHC regime is a bespoke regime that effectively switches off and adapts certain aspects of the UK tax system to mitigate against a number of barriers that have prevented the widespread use of UK vehicles as under the fund AHCs.

Due to the benefits of the regime, there are a number of eligibility requirements to ensure the regime is effectively targeted.

> Only a UK resident company that is a qualifying asset holding company (QAHC) can enter the regime.

A UK resident company will be a QAHC if:

- it meets the ownership condition;
- it meets the activity condition;
- it meets the investment strategy condition;
- no equity securities of the company are listed or traded on a recognised stock exchange or any other public market or exchange; and
- it has elected into the regime.

Points to note

- While a QAHC has to be UK tax resident (i.e. centrally managed and controlled in the UK), it need not be UK incorporated. This means that a non-UK incorporated company can move its residence to the UK to enter the regime. HMT is also separately consulting on allowing offshore companies to reincorporate in the UK.
- This feature will also allow an offshore incorporated company to be used as a QAHC. There are three potential benefits of this:
  - to manage stamp duty/SDRT exposure on a transfer of shares in the AHC;
  - to access a more facilitative corporate regime to make it easier to do share buybacks from the AHC; and
  - for all share buybacks to be offshore source gains (opposed to the pro rated regime for UK incorporated companies).

  While managers may be nervous using (for example) a Channel Islands incorporated AHC to face off against investee jurisdictions, we may see managers adopting a double AHC structure with a UK resident/incorporated bottom AHC and a UK resident/Channel Islands incorporated top AHC.

Ownership condition

The primary and most complex condition to navigate is the ownership condition. Broadly, the QAHC must be held by at least 70% good investors (referred to as Category A investors).

The draft legislation states that if the QAHC does not have tracking securities in issue, the relevant interests in the QAHC held by persons other than Category A investors must not exceed 30%.

If the QAHC has shares (other than fixed rate preference shares) or loans (other than normal commercial loans) in issue that track particular profits or assets to a greater proportion than other profits or assets, the relevant interests in that class of profits or assets held by persons other than Category A investors must not exceed 30%.

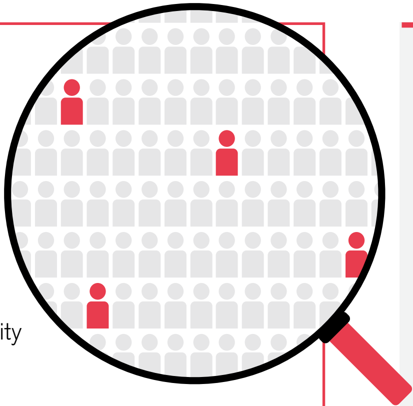
There are ramp up provisions which allow a QAHC two years to meet the ownership condition (if it originally does not) where it reasonably expects the ownership condition to be met within that two year period, which can be extended through agreement with HMRC.

a QAHC
must be held
as to at least
70%
by
good investors

Points to note

- Where a QAHC just has a single shareholder or multiple shareholders holding the same interests proportionately, testing the ownership condition should be relatively easy.
- It will become more complicated where there are tracking securities not held proportionately by all shareholders.
- If the relevant interests add up to more than 100%, the percentages are not scaled down. As the test in the legislation is by reference to the 30% bad investors, not the 70% good investors this rule means that it is easier to fail the test than if interests had to add up to 100%.
- If there are more than 30% non-Category A investors in a class of tracker securities of an AHC, that will disqualify the entire company from the regime, not just the assets tracked by those securities.

Identifying holders of relevant interests



To determine if more than 30% of relevant interests in a UK AHC are held otherwise than by Category A investors it is necessary to identify and quantify the holders of relevant interests in the company. A person holds a relevant interest in a UK AHC if as a result of qualifying shares or loans held directly (or, in some cases indirectly) by the person in the company, the person:

- is beneficially entitled to a proportion of the profits available for distribution to equity holders of the company;
- is beneficially entitled to a proportion of the assets of the company for distribution to its equity holders on a winding up; or
- has a proportion of the voting power in the company,

and the extent of the interest is the greatest of those proportions. There are equivalent rules in relation to tracking securities, but without the voting test.

Qualifying shares and loans take the group relief "equity holder" definition, meaning ordinary shares and loans other than normal commercial loans. The other group relief rules apply in an amended way in applying these tests.

An interest in a QAHC is only taken into account to determine the relevant interests held by a person (T) if as a result of that interest the person is beneficially entitled to profits or assets of the QAHC:

- (i) directly;
- (ii) partly directly and partly indirectly through another person or persons who are not QAHCs; or
- (iii) solely through one or more QAHCs.

For the purposes of (ii) (the directly and indirectly rule), it states that:

- a person is treated as holding an interest directly if they hold an interest through a company, other than a QAHC, that is connected to that person; albeit to avoid double-counting that indirect interest is not then counted for the purposes of measuring the extent of that person's interest (the interest can just qualify them as a direct and indirect holder); and
- a person is taken as holding directly the indirect interests (otherwise than via one or more QAHC) held by a person connected with them who is neither a company nor a Category A investor if those interests would not otherwise be taken into account in determining the relevant interests in the company.

Points to note

- What this means is that it is generally only possible and necessary to look at the direct interest holders of an QAHC in applying the ownership test. The only exceptions to this are where the person holds (or is treated as holding) a direct and indirect interest, where the AHC is owned by a QAHC or where the partnership or trust tracing rules apply (which they do not where the partnership is a qualifying fund). The need to trace through a QAHC means that the 30% permitted bad investors (Category B) has to be applied on a look through basis where there is a chain of QAHCs.
- The directly and indirectly rule is difficult to follow but seems to ensure that the full direct and indirect interest of a Category B Investor is counted where they have a split interest.
- Due to the complexity of the directly and indirectly rule (and in particular the need to identify the indirect interest of any person who holds directly) and the complexity of determining the entitlement to profits and assets of a relevant interest holder, it will be materially preferable if a QAHC only has Category A investors as direct shareholders.
- While votes are used on a basis to determine the extent of relevant interests, this will only be the case when the votes are attached to economic shares as only economic shares are taken into account to determine the holders of relevant interests. This will mean a holder of solely voting shares will not be treated as holding a relevant interest. This will allow the voting shares in an AHC to be held by the manager group or an orphan if this is necessary due to investor requirements (for example where there are Canadian pension fund investors).

Category A investors and qualifying funds

The ownership condition requires that persons other than Category A investors must not exceed 30% i.e. at least 70% of the investors in the QAHC must be Category A investors.

Category A investors include:

- a qualifying fund;
- an intermediate company;
- a QAHC;
- a UK public authority;
- a UK or overseas pension scheme;
- a UK or non-UK authorised life insurance (or similar) company;
- an entity benefitting from sovereign immunity; and
- a charity not connected to individuals managing the QAHC.

A qualifying fund is defined as:

- a CIS which meets the genuine diversity of ownership (GDO) condition; or
- a CIS or AIF which is "not closed".

Points to note

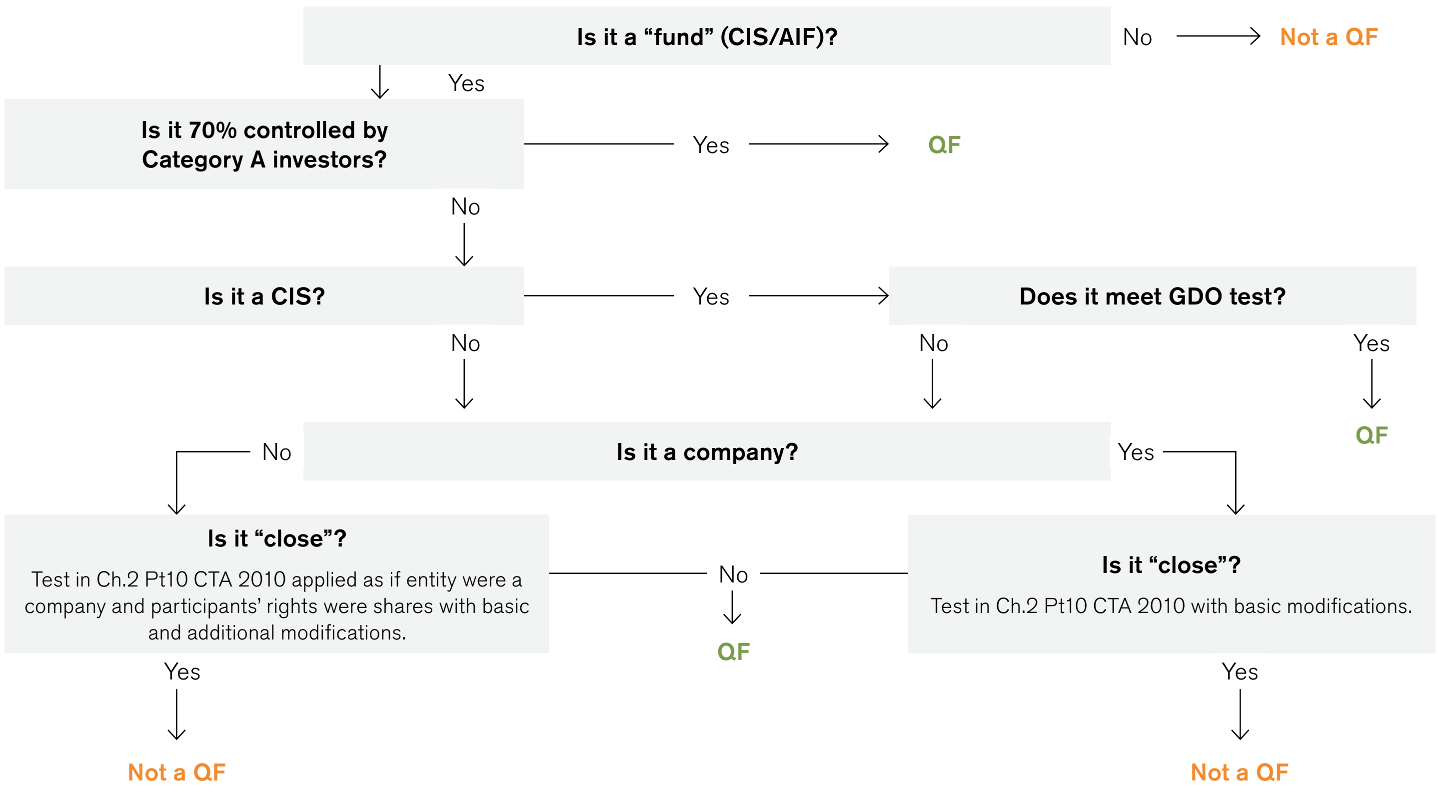
- A close-ended corporate fund is not a CIS and so cannot rely on the GDO condition. It will have to be non-close to be a qualifying fund.
- A co-mingled partnership fund will likely be a CIS and an AIF.
- A "fund of one" may be neither an AIF or CIS (or be both), depending on the circumstances.
- Following revisions to the draft legislation at the Public Bill Committee stage it has become more difficult for a fund of one to qualify. The original test allowed for close funds (that are CISs or AIFs) to qualify where there were Category A investors, however this is now replaced with a new test that is operationally different. The new test allows CIS or AIF funds to qualify if they are 70% controlled by Category A investors. It is not entirely clear why the government has introduced the 70% into the qualifying fund test and we had hoped this would be re-considered. In practice this means qualification will become harder as the 70% test, in particular where there is carry arrangements, is actually a much higher threshold to satisfy. For example, if a fund has a 20% carry, then it will need to have 90% qualifying investors. We have recommended that the government considers a threshold of 51%, which in effect is c70% with a 20% carry arrangement.
- In determining whether a fund is 70% controlled by Category A investors it is necessary to look at voting power and entitlement to income distribution and rights to assets on winding up. Testing the voting rights of investors is a novel approach and one we are not convinced will work in practice. Investors will seldom be asked to vote, and even if they are, it will be on matters at the margin of the funds operation. Getting comfortable that the voting rights are strong enough to amount to "the voting power" in the fund or, in the case of a fund that is not a body corporate, an equivalent ability to "control the fund" feels difficult. We are told that the guidance will provide more comfort on this, however this will not make up for deficiencies in the legislation.
- If a partnership fund of one is not a CIS or AIF, it could still hold a QAHC pursuant to the partnership trace through rules discussed at page 11.

Category A investors and qualifying funds

Points to note

- A great advantage of a fund satisfying the GDO condition is that it need not undertake a (potentially complex and/or uncertain) close company analysis and need not continually monitor its non-close status. Furthermore, it may allow widely marketed but narrowly held funds to qualify as a qualifying fund.
- While the GDO test is perhaps designed for the retail, open ended fund context, it does work in a private closed ended funds context and HMRC's guidance, extracted in part on pages 12-14, is helpful in this regard. As can be seen, with the help of HMRC's guidance, it should be possible for most widely held (non-corporate) private funds to be qualifying funds on the basis of GDO.
- In a corporate fund context, a clearance procedure is available for GDO and we await to see whether this will be made available for partnership funds.
- Currently parallel funds in a single fund structure must be assessed separately and therefore there could be a situation where one could be a qualifying fund and one or more might not be. We hope this issue will be addressed before the rules are finalised.

How to spot a qualifying fund



Close company test

Basic modification

- Applied to UK and non-UK entities.
- Carve out for companies controlled by non-close companies disapplied.
- If using quoted company exemption cannot assume that shares beneficially owned by non-close company held by the public.
- Company not treated as close just because of voting power of manager or general partner of CIS limited partnership.
- Partners are not aggregated.

Additional modifications

- General partner's priority entitlement ignored in calculating any person's interests.
- Carried interest entitlement fixed at maximum overall proportion (rather than actual proportion at any time) when held by a person in connection with the provision of investment management services.

CIS

A CIS is defined in section 235 FSMA as:

"any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income".

The provision goes on to state that the arrangements:

- (i) must be such that the persons who are to participate (participants) do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions; and
- (ii) must also have either or both of the following characteristics – (a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled; and (b) the property is managed as a whole by or on behalf of the operator of the scheme.

However, the law provides that certain entities are not CIS including body corporates which are not open ended investment companies, therefore a closed ended corporate fund is not a CIS.

AIF

An AIF is defined in section 3 of AIFM regulations SI 2013/1773 as:

"a collective investment undertaking….which (a) raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of these investors; and (b) does not require authorisation pursuant to Article 5 of the UCITS directive".

The definition goes on to provide that an AIF may be open-ended or closed-ended, and constituted in any legal form, including under a contract, by means of a trust or under statute. It is stated that none of the following entities is an AIF—

- [a pension fund];
- a holding company;
- an employee participation scheme or employee savings scheme; or
- a securitisation special purpose entity.

Tracing

The ownership condition becomes more complicated in circumstances where it is necessary to trace through a partnership or a company to identify the relevant interests in the QAHC. Generally it is not possible or necessary to trace through a QAHC shareholder but there are certain exceptions.

Tracing through partnerships

Where the direct shareholder of the QAHC is a partnership which is a qualifying fund, it is not necessary to trace through it (although an interest through it can still be an indirect interest for the purposes of the directly and indirectly rule). This means that GPS and carried interest arrangements within a qualifying fund should not be relevant provided the holders are not also direct interest holders in the QAHC. **It is therefore materially preferable to avoid carried interest holders in a fund also being a direct co-investor in an AHC.**

Where the direct shareholder of the AHC is a partnership or bare trust which is not a qualifying fund, then it is necessary to trace through that entity, in which case:

- a GPS for investment management services is ignored;
- an AHC wholly owned by that entity will be a QAHC provided the level of entitlement within that entity of persons who are not Category A investors does not cause the 30% limit to be breached. This is the rule that should allow limited partnership funds of one (which are not a qualifying fund on the basis of being neither a CIS or AIF) with a Category A investor to qualify for the QAHC, subject to the carried interest arrangements.
- While there are special rules which treat the carry percentage in such an entity as the overall percentage, not a higher percentage at different points in a waterfall (for example, during the catch up), as currently drafted, this only helps where the carried interest is held by persons in connection with the provision of investment management services (IMS). This has changed since the Public Bill Committee stage, where the previous version stipulated that the individual had to perform investment management services. The revised legislation relaxes this such that the person's entitlement to carried interest arrangements need only be in connection with the provision of investment management services.

Tracing through companies

It is generally not possible to trace through a company to satisfy the ownership condition other than as part of the directly and indirectly rule (which will apply rarely) although a corporate shareholder can cause a AHC to satisfy the ownership condition if it is a qualifying fund or an intermediate company, each as defined.

Intermediary companies

An intermediary company is a company which meets the activity condition and which is owned as to at least 99% by one or more Category A investor other than a QAHC. The 99% test looks at voting and economic rights.

What this means is that, where an AHC is owned by a company, if that company is not a qualifying fund, it must be 99% owned by Category A investors. In practice, that will not allow the intermediate company rule to be used below a fund of one with a qualifying investor where there is a carried interest – the QAHC would need to be held directly.

Even where the shareholder of the intermediate company is a qualifying fund, the 99% threshold sets a strict test and will likely mean that the vehicle needs to be wholly owned by one or more qualifying fund.

The 99% requirement means that it is not going to be possible to use a QAHC below a Luxembourg AHC where there are non-Category A investors in that Luxco (for example team co-invest or other non-qualifying co-invest).

It is hoped that the 99% requirement will be relaxed before the rules are finalised. There does not seem to be a good policy reason for the higher requirement provided the look through ownership of the QAHC by Category A investors does not drop below 70%.

Genuine diversity of ownership (GDO) condition

A fund which is a CIS can be a qualifying fund by satisfying the GDO condition. The GDO condition is borrowed from the Offshore Funds rules.

The GDO requirement for qualifying funds applies on an accounting period by accounting period basis, although for a closed ended fund, the conditions are likely only relevant for its fundraising period.

HMRC has issued guidance on the GDO condition in relation to its application to the offshore funds rules which we have extracted as it is helpful in relation to the AHC regime.

Condition A

- Condition A is that the fund produces documents, available to investors and to HMRC, which contain a statement specifying the intended categories of investor, an undertaking that interests in the fund will be widely available, and an undertaking that interests in the fund will be marketed and made available in accordance with the requirements of Condition C.
- Condition A is treated as satisfied by a fund marketed before 1 April 2022 if the manager of the fund makes a statement to HMRC that the fund was widely marketed to the intended investors in accordance with Condition C.
- The original draft of the legislation had referred to an arbitary date of 6 April 2020 however this has now changed.

Points to note

In respect of Condition A, HMRC state at IFM17310 that:

"To achieve this the fund must have committed to targeting the categories of investors it has specified and to market the fund and make it available to those target categories. This commitment should be binding and public."

HMRC makes clear that a permitted intended category of investors can be institutional investors i.e. "*investors such as pension funds, sovereign wealth funds and insurance companies*" and in assessing whether the condition is met, "*HMRC will look at the fund documents to ensure that they contain a statement that the units in the fund will be marketed and made widely available. The documents should also clearly specify the intended categories of investor. HMRC will consider whether these are sufficiently wide to ensure that the fund is not limited to a few specific persons named or implied by the given categories.*"

Condition B

- Condition B is that the specification of the intended categories of investor do not have a limiting or deterrent effect and that any other terms or conditions governing participation in the fund do not have a limiting or deterrent effect. A limiting or deterring effect means an effect which (a) limits investors to a limited number of specific persons or specific groups of connected persons, or (b) deters a reasonable investor falling within one of the intended categories of investor from investing in the fund.

Points to note

Condition B states at IFM17320 that:

"The purpose of Condition B is to exclude funds which (notwithstanding anything contained within the fund's documents designed to meet Condition A) are 'private' or only available to specific individual or corporate investors…

The terms and conditions of the fund should not be set in such a way as to limit investment to a select group within the stated categories of investors and they should not deter a reasonable investor within the target market from investing in the fund…

The condition is not intended to prohibit normal commercial variations in charges. It is aimed at situations where the target market is stated to include a particular category of investor but either the charges or the minimum investment are applied in a discriminatory way so as to effectively exclude all but a select few, such as quoting a reasonable market rate annual management charge for favoured persons but a much higher charge for another person within the same category of investor."

Condition C

- Condition C is that interests in the fund must be marketed and made available sufficiently widely to reach the intended categories of investors, and in a manner appropriate to attract those categories of investors.
- Condition C is treated as being met even if at the relevant time the fund has no capacity to receive additional investments, unless the capacity of the fund to receive investments in it is fixed by the fund documents (or otherwise), and a pre-determined number of specific persons or specific groups of connected persons make investments in the fund which collectively exhausts all, or substantially all, of that capacity.
- This easement should allow a closed-ended fund to satisfy Condition C and, in a different context, we have had confirmation from HMRC that a closed ended fund which was widely marketed but which is now closed to new investors satisfied Condition C.

Points to note

The commentary provided by HMRC in relation to Condition C states at IFM17335:

"Marketing for this purpose includes any activity that is designed to bring the fund to the attention of investors within the target market. Where there are a substantial body of unconnected investors in a fund then HMRC accept that this condition has been met...Any activity designed to attract the specified category of investor will constitute marketing for this purpose. This could include: Direct contact such as presentations to or meetings with institutional or high net worth investors or their consultants…"

HMRC also recognises that marketing is not necessarily a continuous activity, *"However, where there is no continuous marketing activity then there must be a clear and continuing intention to make the fund available to its target market or to wind it up. A marketing plan that is documented or recorded may help to satisfy condition C in these instances. HMRC would not seek to exclude a case where a fund starts out with a low number of investors (for example, cornerstone investors), as long as there is subsequently a clear and continuing intention to market and make available the fund to all categories of investors specified."*

HMRC also confirm that marketing activities may not always be required. They state that *"Some specialist funds may not need active marketing to gain the investors identified in the target market, for instance because of the reputation of the fund manager. In this situation, HMRC will accept that Condition C is met where the information about the fund is made available to all investors within the target market and is made accessible to them on request. In these circumstances, as long as there is no evidence of a 'privately owned fund' and there are a number of unconnected investors in the fund, then Condition C will be considered to be met."*

Finally, HMRC state at IFM17375 *"HMRC accept that this condition has been met where there is clear evidence that a substantial part of the fund investors are unconnected, as the marketing would have had to be sufficiently wide to achieve this outcome."*

Non-closeness test

The alternative test to the GDO condition is the non-closeness test and this test can allow both CISs and AIFs to be a qualifying fund.

If the fund is a company, the question whether it is close depends on whether it is a close company for corporation tax purposes (subject to certain modifications discussed on pages 16 and 17).

In the case of a non-company fund, you ask the same question but assuming that the fund is a company and that its participants were shareholders.

An earlier version of the legislation allowed close funds (that are close by virtue of Category A investors) to qualify, however this was removed at the Public Bill Committee stage and replaced with an operationally different test (outlined above on page 7).

A company is generally close under section 439 CTA 2010 if it is controlled or it is majority economically owned by 5 or fewer participators (shareholders and their associates), or participators who are directors.

The test basically requires you to take the fund vehicle being tested, identify the investors in it by tracing through partnerships but not companies, exclude the voting and GPS/management fee interests held by the manager, treat the carried interest held by those in connection with the provision of investment management services as a constant percentage and ask whether the largest five interest holders who are not Category A investors add up to more than 50% by economics or vote.

Most funds which are fairly widely held or which have majority institutional investors should be non-close on this basis. More details on the operation of these rules are set out below.

The concept of a "close company" crops up throughout tax legislation. In broad terms, a UK resident company is close if it is under the control of five or fewer participators or participators who are directors. A company will also be close if five or fewer participators (or participators who are directors) together possess or are entitled to acquire rights which would entitle them to receive the greater part of the assets of the relevant company on a liquidation, with any amounts distributed to intervening companies being notionally distributed on the liquidation of that second company and onwards up a chain.

A participator is a person who has a share or interest in the capital or income of a company. So, by treating participants' rights in a fund as shares in the notional company, the persons who have an interest in those hypothetical shares will be treated as participators. A "participant" in a fund tends to be a reference to the immediate investor, but "participator" is a subtler concept. So, if a partnership (a fund of funds, for example) participates in a fund through its general partner, the participant may well be the general partner, but the participators (when it comes to applying the close company test to the underlying fund) will be the partners in the feeder fund partnership.

References to "control" of a company are to a case where a person possesses or is entitled to acquire:

- the greater part of the share capital or issued share capital of a company;
- the greater part of the voting power in the company;
- so much of the issued share capital of the company as would, on the assumption that the whole of the income of the company were distributed among the participators, entitle a person to receive the greater part of that income or such rights as would entitle a person; or
- in the event of the winding up of the company or in any other circumstances, to receive the greater part of the assets of the company which would then be available for distribution among the participators.

If two or more people together satisfy any of these conditions, they are taken to have control of the company.

In determining the rights a person has, they are treated as entitled to acquire anything which they are entitled to acquire in the future or will in the future be entitled to acquire. There may also be attributed to a person all the rights of powers of any company of which that person and their associates have control or the rights and powers of any of that person's associates. Associates includes relatives, related settlements and partners.

In very broad terms, therefore, if more than half of the economics of a company (measured by reference to income or capital) or the votes in a company is held by five or fewer people (treating associates effectively as a single holder) then the company will be close. However, a company is not to be treated a close company if it is controlled by one or more companies none of which is a close company and cannot be treated as a close company except by taking as one of the five or fewer participators requisite for its being so treated a company which is not a close company.

A company is also not treated as a close company if shares in the company carrying at least 35% of the voting power have been allotted to and are beneficially held by the public and any such shares have within the preceding twelve months been the subject of dealings on a recognised stock exchange.

In its application for these purposes, the close company test is modified in a number of respects. These modifications are based on (but are not exactly the same as) a similar test in the non-resident CGT rules.

- First of all, a non-resident company can be close just as much as a UK one.
- The exception for a company which is controlled by non-close companies and cannot be treated as close on any basis without taking the interests of non-close companies into account is disapplied.
- Similarly, the rule which treats shares beneficially owned by a non-close company as being owned by the public for the purposes of the quoted company exception discussed above does not apply.
- Most importantly for us, partners in a partnership are not treated associates. Taking this together with our view of who the participators are where an investment in a fund is held by a partnership, investors in a fund of funds partnership which holds a stake in an underlying fund under consideration can all be looked at separately with no aggregation of the partnership's interest. If the feeder is a corporate vehicle, there is no similar look through even if the fund is controlled by one or more non-close corporate feeders.
- Finally, a company is not to be regarded as a close company just because a person possesses or is entitled to acquire the greater part of the voting power in the company as a result of being a manager of a collective investment vehicle or a general partner in a collective investment scheme limited partnership. This deals with directional, voting control by a fund manager but not economic control, which we discuss on the next page.

General partner's share/carried interest issues

A typical fund waterfall will allocate all of the income/gains realised by the fund in any particular period to the general partner up to a limit (normally a percentage of the total amount committed to the fund). If there are insufficient profits in a particular period, the fund will advance the shortfall to the general partner as a loan (using money drawn down from investors) and there will be a "catch up" allocation of income and gains to the general partner in a future period.

Subject to distributions to the general partner all income and gains are then typically allocated to investors (and proceeds distributed to them) until they have received back all the money they invested in the fund together with a preferred return. After that, the carried interest holders would be entitled to all of the distributions until their drawings from the fund have "caught up". So, for example, if the carried interest is intended to be 20% of the profits of the fund, carried interest holders will at this stage in the waterfall be entitled to all of the distributions in the fund until they have received an amount equal to 20% of all the distributions in excess of the return of capital contributions made both to them and to the investors. Thereafter, economics will be shared in the agreed ratio (typically 80:20) between investors and the carried interest holders.

This waterfall is important when it comes to looking at how the close company test is to be applied to a limited partnership fund. As we have already seen, the voting control which a general partner or manager of a fund has is ignored in determining whether the fund is close. However, the economic entitlement of the general partner is not ignored and that is likely to mean, certainly in the early years of the fund, that the fund will be close if all of the general partner's share is paid to a single corporate general partner. Similarly, if during the carried interest "catch up" period more than half of the carried interest distributions are in fact enjoyed by five or fewer carry holders, that of itself may make the fund close. As we have seen, the legislation treats a person as entitled to acquire anything which they are entitled to acquire at future date or will at a future day be entitled to acquire. It is not clear whether those provisions would treat carried interest holders as entitled to amounts which would be distributed to them if (but only if) a carried interest hurdle is met.

To address these issues certain additional modifications are made to how the close company test is applied to a non-corporate fund. Firstly, the general partner's priority entitlement is ignored in determining any person's interests in the fund. Secondly, where a person has a profit entitlement under "investment management profit-sharing arrangements" the person is taken to have the maximum proportional entitlement that could arise over the life of the arrangements rather than the actual proportion at any time. So, on our example waterfall the total carried interest entitlement would be 20% (not the 100% it could be during the "catch-up" phase). One drafting point to note here is that the revised draft legislation (post Public Bill Committee stage) did away with requiring the person to "perform" investment management services. This is a helpful development for arrangements that involve an affiliated company or a family trust.

Points to note

The test whether a fund is close or not is applied separately at the level of each entity which constitutes a fund.

Funds will sometimes comprise of a number of parallel partnerships, all of which are managed in the same way and have broadly the same (if not identical) investment strategy/portfolio. The reality is that, although different partnerships may be created in order to accommodate the needs of particular investors, each of these partnerships is no more than a part of a single fund. Where a parallel partnership is constituted to meet the needs of a small number of investors, it is likely to be close, whereas the totality of the parallel vehicles judged together would not be.

Because the QAHC regime is a beneficial tax regime, it will be for the QAHC to demonstrate that, although it is a UK tax resident company, it benefits from the regime and is not fully taxable. It is very helpful in this regard that connection by virtue of partnership (which is how most independent investors are likely to be connected) is left out of account. There are, however, other ways in which investors in a fund could be connected or associated (most obviously, group companies are associated) and the same entity may be a participator in an underlying fund through more than one entry point (eg through different funds of funds). In many cases, at least at an impressionistic/common sense level, one might readily conclude that investors in a particular fund have nothing to do with each other but the important question is the extent to which a fund manager needs to be able to prove that it is actually not close in order for an underlying company to be able to conclude that it meets the ownership condition. If a fund manager/QAHC needs to be able to prove that a fund is not close, the legislation is unlikely to work. If, however, it is sufficient for it to be reasonable to suppose that a fund is not close, then there is no reason in principle why the non-close test should not work well.

One disadvantage of a non-close test compared with the GDO test, of course, is that it needs to be applied from time to time and, in a fund with a typical waterfall and where there is a degree of secondaries trading in investor interests, there might be a different answer at different stages in the life of a fund. However, as long as a relatively light touch is taken to the level of diligence required and the closeness of the fund is judged by looking at the totality of parallel vehicles, there is no reason in principle why this test should not work tolerably well for many funds.

Activity and investment strategy conditions

In addition to the ownership condition, a QAHC must satisfy the activity and investment strategy conditions.

Activity condition

The activity condition states that the main activity of the AHC is the carrying on of an investment business and that any other activity is ancillary to the carrying on of that business and is not carried on to any substantial extent.

Investment strategy condition

The investment strategy condition states that the AHC's investment strategy should not involve the acquisition of equity securities that are listed or traded on a recognised stock exchange or any other public market or exchange or other interests that derive their value from such securities, other than for the purpose of facilitating a change in control of the issuer of those securities with the result that its securities are no longer so listed or traded.

Points to note

Activity condition

- The aim of the activity condition is to ensure that the QAHC is not used as an operating business (or at least not to a substantial extent).
- The guidance around carrying on an "investment business" will be important to gain comfort that activities like strategic management advisory services or portfolio asset management services which generate an income stream are not caught although in any extent they would not normally be substantial. We believe that "investment business" extends to loan origination and almost all credit strategies and expect this will be confirmed in HMRC guidance.
- The terms "ancillary" and "substantial extent" are not defined in the legislation. It is still to be determined whether substantial will take a similar meaning to its use within SSE legislation where 20% is indicative of substantial.

Investment strategy condition

- The rationale behind the investment strategy condition is to provide comfort to HMRC that QAHCs will not be used as a vehicle to acquire listed securities and convert income into capital gains. This resulted in the removal of more complex tracing provisions.
- The legislation does not articulate what the investment strategy must consist of, but it appears clear that it is the QAHC's investment strategy, rather than the fund's strategy. It is also not clear how one should determine the QAHC's investment strategy other than by looking at what it owns.
- Where a QAHC does acquire listed securities it will need to demonstrate that the purpose of the acquisition is to ultimately change the control of the company and to delist it (i.e. it is a public to private transaction). The legislation does not stipulate over what period of time, nor does the condition restrict it to certain size stakes. The investment strategy condition will allow AHCs to hold listed shares following an IPO of a previously unlisted investment as that holding would not be an acquisition forming part of an investment strategy.

Main tax benefits of the UK AHC regime

The overarching design of the regime is to ensure that the vehicle provides tax neutrality (i.e. minimal tax) by switching off or adapting aspects of the UK tax system. This will ensure investors are not disadvantaged in their use of an AHC platform compared to making those investments directly and means the UK regime is comparable to other jurisdictions.

There are a number of key tax benefits of the UK AHC regime.

- A gain accruing to a QAHC on a disposal of (non-UK property rich) shares is exempt from corporation tax on chargeable gains. There are no conditions attached to this exemption.
- Payments of interest by a QAHC are not subject to withholding tax (the UK does not impose withholding tax on dividends or other distributions).
- Various rules denying or delaying a deduction for finance returns on (principally) shareholder debt are switched off. In particular:
  - the deemed distributions rules which are applied to securities which are convertible into or stapled to shares are switched off, as are the equivalent rules for securities where the return is results dependent or excessive; and
  - the late interest rules and equivalent deeply discounted securities rules are switched off ensuring a deduction on an accruals basis.
- A payment made by a QAHC on the redemption, repayment or purchase of its own shares is treated as a capital distribution within the capital gains regime unless those shares are held by a portfolio company executive (i.e. the shares are an employment related security held by a manager in a 25% subsidiary of the QAHC). A fund executive is specifically excluded from this exclusion so can benefit from capital treatment.
- The transaction in securities rules are also switched off in this context ensuring capital gains tax treatment for the share buyback. Further, such a transfer does not attract stamp duty.

Entry, exit, administration and other provisions

The AHC regime provides for existing companies to be able to gain access to the regime and also recognises that companies could either unintentionally breach the conditions or wish to leave the regime.

A QAHC has to elect into the regime and is able to elect out of the regime as well. A QAHC can also be expelled from the regime in certain breach scenarios.

Points to note

Entry and exit

- A new accounting period for corporation tax purposes is created on entry into the regime. Similarly, on exit the accounting period ends.
- On entry and exit, there is a deemed disposal and reacquisition for market value of shares and overseas property related assets. If the deemed disposal would qualify for the SSE on the way in but for the fact that the shares have been held by the QAHC for less than 12 months, the SSE continues to apply if the AHC goes on to satisfy all of the SSE conditions at the end of the 12 month holding period.
- The deemed disposal and reacquisition on entry does not apply to assets of a non-resident company becoming UK resident in the 30 day period prior to becoming a QAHC. This is to allow non-resident companies to redomicile to the UK in order to enter the regime.

Administrative matters

- A company that wishes to be a QAHC must make an entry notification to HMRC.
- A company becomes a QAHC at the beginning of the first day on which all of the relevant conditions are met including an entry notification having effect (note that a QAHC can enter the regime before the ownership test is met under the two year ramp up provisions discussed above).
- The QAHC business within the regime (the QAHC ring fence business) is all of its activities in relation to the holding of shares, loans and any related derivative contracts.
- A QAHC must take reasonable steps to monitor whether the ownership condition continues to be met in relation to it.
- A QAHC must provide certain financial information in relation to the assets, proceeds and activities with its tax return including an estimate of the market value of the assets of the QAHC's ring fence business as at the end of that accounting period.
- A company can give a notification to exit the regime and must notify HMRC when it ceases to meet any of the eligibility requirements.

Points to note

Other provisions

Curing breaches

In the event that the QAHC breaches certain conditions, it is possible for a QAHC to cure the breach.

A non-deliberate breach of the activity condition is cured if it is remedied as soon as is reasonably practicable and a notice is made to HMRC regarding it.

A QAHC is also given a cure period in relation to a non-deliberate breach of the ownership condition if the 30% threshold is not breached by more than 20% (i.e. not more than 50% bad investors) and the QAHC has complied with the ownership test monitoring requirements.

The "cure period" is:

- the period of 90 days beginning with the day on which the QAHC became aware of the breach; or
- such longer period beginning with that day as HMRC may in writing agree to.

There are provisions to allow a QAHC two years to wind down within the regime where the breach is as a result of a qualifying fund invested in the QAHC ceasing to be a Category A investor or a buyback of interests by a QAHC provided it does not acquire any "optional" assets or raise any capital during the wind down period (in which event the period immediately ends). The wind down period can be extended by agreement with HMRC.

Ring fencing

There are provisions to allow a QAHC to carry on activities within the QAHC regime and activity outside that regime (including activities of the company before it became a QAHC and after it ceased to be one) with a QAHC to be effectively treated as two companies – one carrying on the QAHC activity and one not. Losses cannot be surrendered between "companies" on either side of the ringfence, and assets transferring within a company across the ringfence are treated as disposed of and reacquired for market value. Easements are provided if that gain has been taxed already.

QAHCs treated as close companies

Even if it would not otherwise be, a QAHC is treated as a close company meaning that rules such as the loan to participator rules apply to it.

Group relief

There are various group relief and continuity rules in relation to QAHCs and the transfer of assets within the same group.

Exchange gains

The loan relationship and derivative contracts (exchange gains and losses using fair value accounting) regulations are amended for QAHCs such that the exchange gain or loss is calculated by reference to the change in fair value between the fluctuations in the spot rate.

Application of the corporate interest restriction rule

The AHC regime amends the corporate interest restriction rules such that the group does not include the QAHC subsidiaries that are portfolio entities where they are held as a market value investment.

Distributions to remittance basis users

UK resident non-domiciled individuals eligible for remittance basis taxation do not ordinarily pay tax on foreign income or gains unless they are remitted to the UK. However, they pay tax on the arising basis in relation to UK source income and gains.

Without any specific rules, all income and gains arising from a UK AHC would be UK source even if they derive from underlying non-UK income and gains (i.e. using a UK AHC would convert offshore income and gains taxed on the remittance basis into UK income and gains taxed on the arising basis). The regime includes special rules to alleviate this point.

There is also the question whether making investments into the AHC constitutes a remittance. There are no special rules addressing this question and reliance needs to be placed on the existing arguments why this is not a remittance (where those are available). These rules are complex and are considered further here.

Without any specific provision, profits arising from a QAHC would constitute UK income/gains taxable on the arising basis even to non-domiciled remittance basis users.

However, under special rules within the regime, profits arising to a remittance basis user as a result of a payment of interest or a distribution by a QAHC (including a payment of interest or another distribution on a security which is not treated as a distribution by the QAHC rules) or a disposal (including buyback or redemption) of shares in a QAHC can be divided into a UK and a foreign proportion if the individual provided investment management services in respect of the investment arrangements to which the QAHC is a party (so, including providing such services to a fund which owns an interest in the QAHC) and, in the case of a disposal of shares, acquired those shares during the course of providing those services.

The foreign proportion of any income or gain reflects the proportion of the profits of the QAHC's ring-fenced business in the relevant period that were derived from foreign sources, apportioned on a just and reasonable basis. For these purposes, the "relevant period" means the last three complete accounting periods of the QAHC if the company has been a QAHC for at least three accounting periods. Otherwise, it means the period beginning with the day on which the company became a QAHC and ending immediately before the time when the income or gain arose.

As well as looking at income and gains which actually arose in that period, it is to be assumed that the QAHC disposed of all of the assets within its ring-fence business for a consideration equal to their market value immediately before the end of the relevant period. In other words, the test is looking to see what the UK:foreign profit split would be based on actual profits in the previous three years assuming the QAHC realised all its remaining assets.

Whether profits are derived from a foreign source is to be determined by reference to the ultimate underlying income or assets to which the profits relate. So, if a QAHC holds shares in a French holding company which has subsidiaries in the UK and abroad, each of those subsidiaries (but not every last transaction entered into by each of those companies) would be an ultimate underlying source of profit. The legislation does not set out how the split is to be calculated, simply that it needs to be "by reference to" ultimate underlying income or assets, so on a sale of the French company in this example, the UK:foreign split might reflect the relative values of the UK and foreign subsidiaries or their contributions to group profitability.

Points to note

> This relief is both complex and restricted. It is only of benefit to investment managers and only in relation to determining whether profits they derive from a QAHC are UK or foreign income or gains.

The procedure for working out the UK and foreign proportions needs to be operated every time income or gain arises until the QAHC has three complete accounting periods under its belt. The calculation requires valuations of existing assets and some diligence around where they carry on their activities and the exercise of judgement around the relative importance of those locations.

Unless the QAHC's underlying investments are all non-UK, the calculation will always produce some UK income or gains. An investment in a non-UK AHC would produce only foreign income and gains.

One helpful point is that HMRC has confirmed in principle that (as is already the case with carried interest arising to remittance basis users) it will be possible to split a distribution into UK and non-UK proportions to avoid creating a mixed fund.

It is important to remember that these rules do not affect the UK:non-UK split of gains chargeable under the special carried interest regime. This depends on where the relevant executive performs the services that gave rise to the carried interest and is unaffected by whether a UK QAHC is used.

The provisions do not help external investors in the QAHC. All the income and gains they derive from a QAHC will be UK income/gains, even if all the activities of the QAHC's investments are carried on abroad. So a QAHC will not be attractive to a UK resident non-domiciled third party investor investing into a tax transparent fund which invests into the QAHC. As mentioned earlier, using a non-UK incorporated but UK tax resident QAHC as the parent company of a UK incorporated and tax resident QAHC may improve the position as far as gains are concerned.

Remittance basis users are taxed on foreign income and gains remitted to the UK and there is a question whether a direct or indirect investment into a QAHC will constitute a remittance. The rules do not contain any new relief in this regard and it is necessary to rely on existing arguments that a remittance does not arise in this situation.

Where a non-UK partnership fund invests in a QAHC there is a technical position (supported by HMRC guidance) that this is not a remittance (on the basis that a "genuine" partnership is not a relevant person). So there is a route to there being no remittance on an investment by an offshore partnership into a QAHC but some advisors may not be comfortable relying on this position and guidance particularly where all investments into the partnership are routed into the QAHC. A QAHC could itself be a relevant person for an investor in the fund and so an investment in the UK by a QAHC could trigger a remittance by an investor, but there is also guidance from HMRC that this may not trigger a remittance at least as long as the QAHC (or the fund which owns it) also makes non-UK investments, so that it cannot be said that any particular investor's funds have been used to make an investment in the UK. A direct investment into a QAHC or into a UK partnership will always have the potential to trigger a remittance.

Corporate law considerations

The UK AHC regime will allow profits distributed on a share buyback to be taxed as capital gains and we expect this route to be used to repatriate underlying equity gains to investors as capital gains. Where the QAHC is a UK incorporated company, a share buyback gives rise to UK corporate law considerations.

Points to note

The starting point for a share buyback is that the company must use its distributable reserves or (subject to certain restrictions) the proceeds of a fresh issue of shares made for the purpose of financing the buyback, to pay for the shares the AHC wishes to buyback. Although there is an exception for small buybacks out of capital, this is unlikely to be useful in these circumstances. The company's distributable profits are its accumulated realised profits less any accumulated realised losses in each case determined in accordance with GAAP.

As noted, repatriation via a share buyback is limited to the distributable reserves. In order to repatriate the underlying investment cost, there are a couple of other methods. These include a buy-back out of capital and a reduction of capital.

The latter is easier and more commonly used. Under a reduction of capital, the company reduces the amount of its share capital by reducing either the number of shares or the value of shares in issue. Alternatively, or in addition the company can reduce its share premium account. There are certain other reserves that can be reduced, but they are less common.

Under this procedure, the company can either create distributable reserves, which can then be used to fund a buyback or (more commonly) make a straight capital payment directly to its shareholders (the fund). In order to carry out the reduction of capital, either the company must seek a court order sanctioning the reduction, or more commonly, the directors must make a statutory solvency statement confirming that they have formed the opinion that, as at the date of the statement, there are no grounds on which the company would fail to meet certain solvency tests. In either case, the reduction must be approved by the company's shareholders by way of special resolution

Accounting considerations in a credit AHC context

As part of the utilisation of a UK AHC by a credit fund, the accounting standards chosen could give materially different outcomes and add volatility to the profit and loss account. In order to determine the accounting treatment, it is first important to establish the relevant GAAP, as well as the accounting elections which may be permissible.

Under IFRS, the governing accounting standard is IFRS 9.

Under UK GAAP, FRS 102 has three permissible accounting standards which it refers to for debt financial instruments:

- sections 11 and 12 as set out in FRS 102;
- IAS 39 Financial Instruments Recognition and Measurement (as written at the date that IFRS 9 came into force); and
- IFRS 9 Financial Instruments.

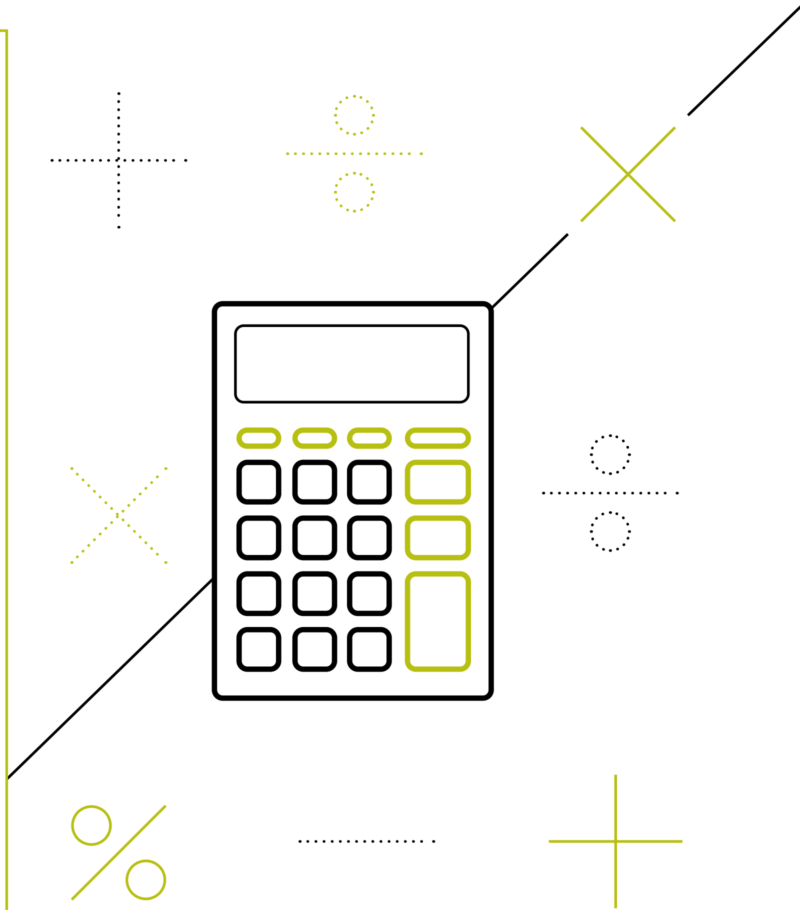
The latter two have the same disclosure requirements as section 11 and 12.

IFRS 9

- All recognised financial assets that are in the scope of IFRS 9 are measured either at amortised cost or at fair value.
- In accordance with IFRS 9, a debt instrument is generally measured at amortised cost (using the effective interest rate method, less provision for impairment) if both the "business model test" and the "contractual cash flow characteristics test" are satisfied.
- The business model test is whether the objective of the entity's business model is to hold the financial asset to collect the contractual cash flows rather than have the objective to sell the instrument before its contractual maturity to realise its fair value changes.
- The contractual cash flow characteristics test is whether the contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding. This can incorporate fixed and/or floating rate interest but not, for example, where there is a conversion element on a loan.
- All other debt instruments held must be classified and measured at fair value through profit and loss (FVTPL).
- IFRS 9 contains an option to classify financial assets that meet the amortised cost criteria as at FVTPL if doing so eliminates or reduces an accounting mismatch (e.g. there is a related interest rate swap which needs to be fair value reported).
- All derivatives within IFRS 9 must be measured at fair value.

FRS 102

- Under FRS 102 sections 11 and 12, debt instruments have to be characterised as either basic or other (i.e. more complex). If a debt instrument is basic, it is initially recognised at a carrying value equivalent to the transaction price, including transaction costs (unless accounting at fair value through profit and loss eliminates or reduces an accounting mismatch or there is a portfolio which is managed on a fair value basis). After initial recognition loans are subsequently measured at amortised cost using the effective interest rate method less impairment provisions.
- The effective interest rate is a method calculating the amortised cost of a financial asset or financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate discounts estimated future cash payment or receipts throughout the expected life of the financial instrument, or when appropriate a shorter period, to the net carrying amount of the financial asset or financial liability.
- Other debt instruments are measured at fair value through profit and loss.
- If the simplified accounting offered by sections 11 and 12 do not offer sufficient options as to the accounting choice for an FRS 102 reporter to adopt suitable to their business model, there is the option to utilise IAS 39 or IFRS 9 accounting.
- IAS 39 is typically preferable for businesses who used to adopt FRS 26, or would like to account for fair value items through the available for sale reserve rather than in profit and loss. Whilst this accounting standard is currently permissible, the widening adoption of IFRS 9 means that there is a possibility that in the three yearly cycles of improvements to FRS 102, this option could be removed.
- IFRS 9 is required by all IFRS reporters and therefore most international investors are more familiar with its requirements, meaning that firms may choose to adopt this standard for comparability to the wider market.



Points to note

- In making the accounting choice, a key consideration is how the underlying portfolio is managed and monitored. If the basket of loans held in the AHC are in most cases likely to be held to maturity, amortised cost accounting would be the simplest form of accounting to adopt. However, in the event of an impairment, this would mean that a loss in the year would need to be recognised.
- If the fund provides funding to the AHC on a limited recourse basis to finance the underlying portfolio, the complexity and volatility of that instrument may well mean that it needs to be accounted for either on a fair value basis or bifurcated to have a amortised cost and fair value component. If it is fair value accounted for, it may be worth considering whether the portfolio of underlying loans are actually managed on a fair value basis too or whether fair value accounting may help to reduce or eliminate an accounting mismatch, such that fair value accounting can be adopted for the portfolio of loans.
- If fair value accounting can be adopted and the business is sufficiently set up to run the ongoing fair value models, it is likely that any loss in the fair value of the loans would be offset by a corresponding gain in the limited recourse loan provided by the fund. (This assumes that the level of funding provided by the fund is not permanent and any further reductions in value are not considered to be capital contributions which are taken straight to equity, which will typically be determined by the substance of the loan and how it is managed.)
- If an element of the basket of loans is subject to any performance upside, this may also mean that similar to the limited recourse loan from the fund, that the loans need to be fair valued or bifurcated to account separately for the fair value component. In this case, if both the limited recourse loan and underlying portfolio of loans have a fair value component, it is likely these will offset in the income statement and afford some buffer from impairment. However, if a significant impairment event occurred, it is possible that an impairment of the loans at amortised cost would need to be recognised in the income statement, thereby potentially creating losses in the AHC which may not tally precisely to the movement on the loan from the parent fund in future years.
- If an overall fair value basis is adopted, provided that the impact of any debit value and credit value adjustments between the limited recourse loan and the portfolio of loans is immaterial and that fair value through profit and loss is applicable to the way in which the loans are managed, the annual impact in the income statement may be fairly stable on a net basis.
- From a tax perspective, the critical point is to avoid a significant loss on an impairment that is then recovered. Due to the way the UK loss restriction rules work, the amount of profit that can only be relieved by carried forward losses is restricted to 50% to the extent the losses used exceed £5m. This should hopefully be manageable, but the accounting will be critical to ensuring that is the case.
- Once an accounting treatment that suits the way in which the portfolio is currently managed is determined, providing sufficient rationale and supporting documentation to your independent auditors to support such a material consideration will be critical.

Unresolved issues

Points to note

Issues that could be potentially fixed in draft Finance Bill 2021-22

GDO and close-ended corporate funds

As the rules stand the application of the GDO condition will not work for closed-ended corporate funds. It is unclear why the government has adopted this approach and it could impact credit funds, who since the introduction of the EU wide anti-hybrid rules have increasingly used a corporate vehicle as their master fund.

Parallel partnerships

Where a fund is comprised of a series of parallel funds, the qualifying fund test must be applied on an entity by entity basis, not on an aggregate basis. This might mean that an entity fails to qualify as a qualifying fund in circumstances in which, were a master aggregator fund to have been used, it would have been a qualifying fund. We understand HMT/HMRC might be amenable to addressing this issue before the legislation is finalised.

Tracing through companies

As highlighted, it is generally not possible to trace through a company to satisfy the ownership condition which means that where a QAHC is owned by a company, that company will need to be either a Qualifying Fund or an Intermediate Company. As noted above, the issue is that an Intermediate Company can only have 1% Category B investors, not 30% as with the QAHC itself. We believe the 99% condition in the definition of Intermediate Company should be relaxed down to 70% provided there is at least 70% effective ownership of the UK AHC by Category A investors. HMRC hold some concerns that this could be used as an opportunity to convert non-Category A investors into Category A interests, however provided the 70% test works on a look through basis this should be manageable. We again hope this issue will be addressed before the rules are finalised.

Points to note

Other issues running to an undetermined timetable

Contingent purchase price forwards

The government is exploring changes to the tax treatment of derivatives used to hedge foreign currency risk on acquisition of shareholdings as a potential tax charge could arise in the AHC under the existing law. The issue arises in situations where the AHC does not own any shares at the time of the hedge, and so the disregard regulations/hedging rules do not assist. We are expecting this to be fixed from 1/4/22 or shortly thereafter pursuant to a separate consultation.

VAT

Supplies made by a UK holding company will usually fall under one of the finance VAT exemptions and will therefore only give the UK AHC entitlement to input tax recovery to the extent that the recipients of the supplies belong outside the UK post Brexit.

A UK AHC making supplies to non-UK recipients (e.g. EU recipients) should therefore be able to recover VAT on its costs which is attractive. In contrast, a UK AHC making supplies to UK recipients is typically unable to recover much, if any, of its input tax but this is not usually a material concern.

There is a wider review of VAT in the investment management industry which is due to start in the coming months which will pick up the application to AHCs.

Aggregation of portfolio holdings and application to SAO

The government has suggested that the senior accounting officer (SAO) provisions should apply where a company that is a qualifying company for the purposes of the SAO legislation is also a QAHC. The group definition may be problematic where portfolio groups are owned by a common holding company. Where the QAHC is UK incorporated, this could lead to the amalgamation of the turnover and balance sheet totals of otherwise unrelated groups and drag portfolio companies into certain reporting requirements when they would otherwise not, although the rules do allow different companies within a SAO group to have their own SAO.

Employment related securities (ERS) rules

For the purposes of the ERS legislation the holding of a directorship is treated as an employment, which may implicate UK based executives who sit on the board of the UK AHC who are otherwise a self-employed LLP members. Whilst we believe it would be clear that securities comprising of carried interest would not be acquired by reason of the executives' directorship in the AHC (rather they are afforded to an executive by virtue of their role as a member of the fund manager), we believe it would be helpful for HMRC to set out in guidance that this is in line with their view.

Issues not expected to be fixed

Stamp duty

Although a stamp duty exemption is provided in relation to share buybacks, the exemption does not in its current form extend to intra-group transfers for example if there is a transfer of an AHC between related funds. In addition, the government did not opt to provide an exemption for a UK AHC wholly owning non-UK shares (the comparison being the sale of non-UK shares would not attract stamp duty if there was a direct sale). We feel this is a missed opportunity and may encourage the use of non-UK incorporated AHCs in order to manage the stamp duty exposure.

Excluded index securities (EIS)

One of the key attributes of the AHC regime is the necessity to ensure that the vehicle does not unduly convert underlying capital gains into income through the AHC. As explained, the regime provides a mechanism for equity investments by treating a share buyback as a capital transaction, however for pull to par gains on loans, this will be more difficult. The government currently suggests using the EIS regime however this is complex. We would like to see a further exception from the deeply discounted securities rules for a security issued by a UK AHC the effect of which is to repatriate underlying gains on loans otherwise it will be difficult to return gains on debt as capital gains through a UK AHC.

Comparison of UK and Luxembourg

It is useful at this point to consider how the new UK AHC regime will stack-up against Luxembourg. This comparison is based on the current draft legislation.

Points to note

Pros of UK v Luxembourg

- Broad gains exemption for shareholdings without participation exemption criteria.
- With all profit on debt treated as interest equivalent, a much clearer position on interest barrier rules.
- UK will not be subject to ATAD III substance requirements.
- No WHT on dividends.
- Outside of offshore fund rules.
- No net wealth tax.

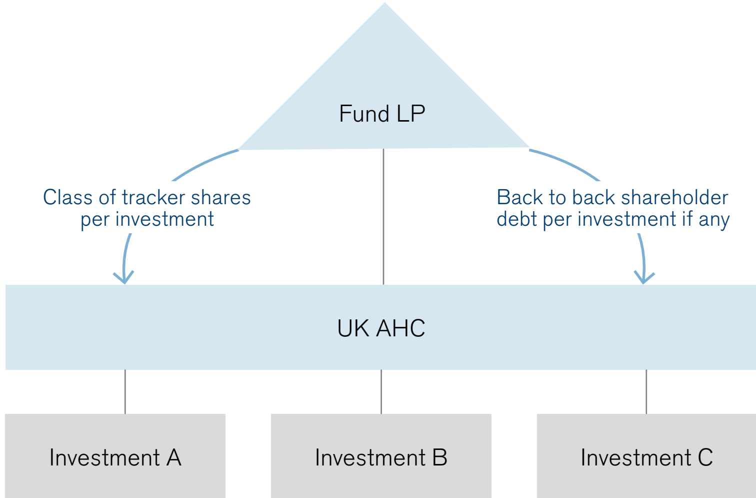
Cons of UK v Luxembourg

- Eligibility criteria.
- Stamp duty on transfer of shares.

Application to a typical private equity fund structure

Resolved issues

- Exemption for gains on equity investments without need to satisfy SSE conditions.
- Profits extracted on buyback of tracker shares treated as capital gain for UK recipients in fund.
- Deduction for return on back to back debt should not be denied or deferred under distribution or late interest rules.
- Shareholder debt remains subject to anti-hybrid rules but those rules work in similar way to Luxembourg rules and should be manageable.
- No interest WHT on shareholder or third party debt.
- AHC should just pay tax on transfer priced (minimal) margin with AHC on flow through shareholder debt.



Issues to consider

- Deal contingent forwards until law changes.
- VAT: ensure no services for consideration are provided by portfolio manager to AHC (same issue in Luxembourg).

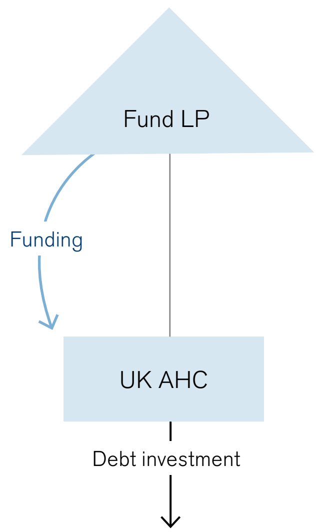
Benefits of UK AHC regime vs Luxembourg

- Broad capital gain exemption without participation exemption requirements.
- No issues with offshore funds rules.
- UK not subject to ATAD III substance requirements.
- No WHT on outbound dividends and interest.

Application to a typical credit fund structure

Resolved issues

- Deduction for return on back to back debt should not be denied or deferred under distribution or late interest rules.
- Shareholder debt remains subject to anti-hybrid rules but those rules work in similar way to Luxembourg rules and should be manageable.
- No interest WHT on shareholder or third party debt.
- Exemption for gains on equity investments/warrants.
- Provided accounting is managed, should just pay tax on transfer priced (minimal) margin within AHC.



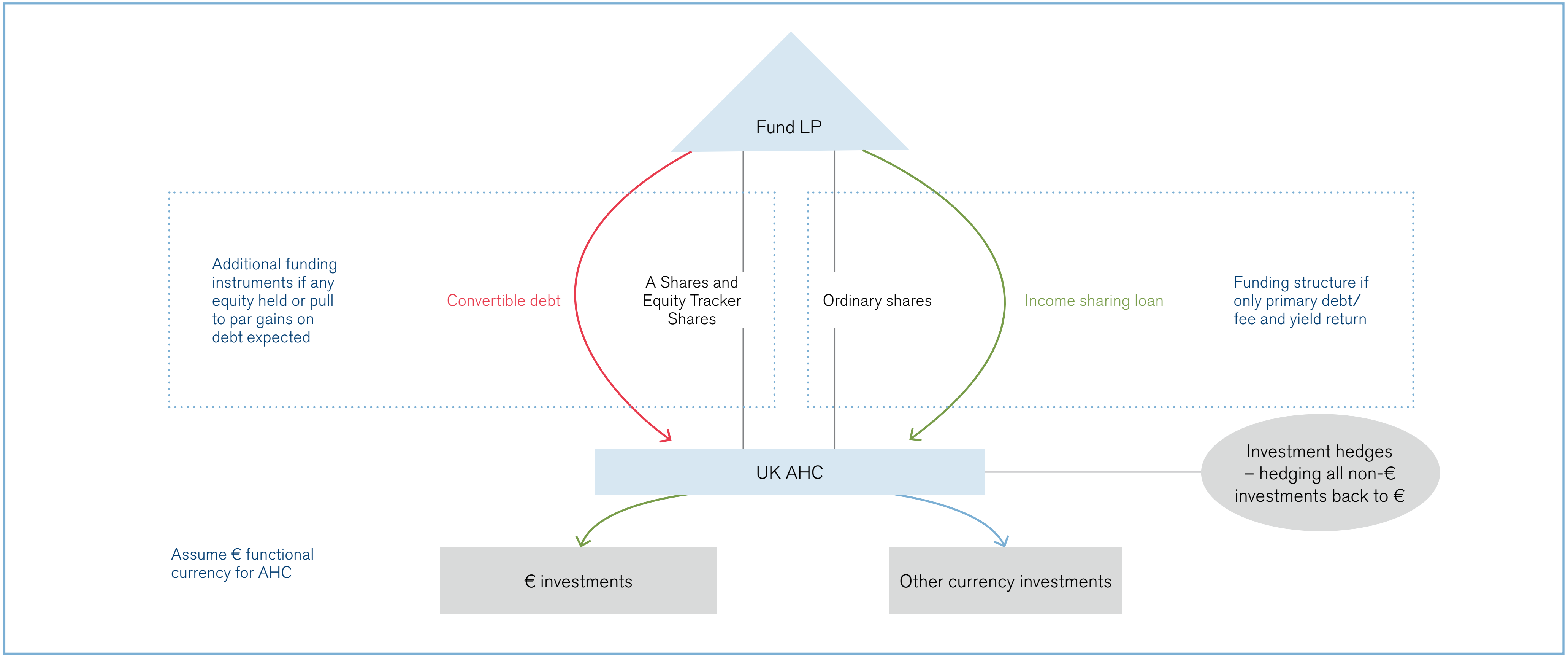
Issues to consider

- Accounting within AHC to avoid mismatches.
- VAT: ensure no services for consideration provided by portfolio manager to AHC (same issue in Luxembourg).
- Repatriating gains on secondary debt as gains reliant on EIS rules.

Benefits of UK AHC regime vs Luxembourg

- No interest barrier concerns on sheltering profit on secondary debt.
- Total capital gain exemption without participation exemption requirements.
- UK not subject to ATAD III substance requirements.

Example: potential credit fund AHC funding structure



In a credit fund context, the funding of the UK AHC will be dictated by the investment strategy, the accounting approach and the position of investors and there will not be a one size fits all approach.

The proposed structure will also be impacted if there is a desire to extract underlying pull to par gains on debt to investors as capital gains. As such gains will require a finance cost deduction on the liability side to shelter the profit, a capital gain will have to be delivered on an instrument which benefits from an exception from the DDS rules. This will likely require the security to be structured as an excluded indexed security – an instrument where the amount repayable (other than interest) tracks up and down the value of a capital gains tax asset. In practice, this would need to be achieved by a debt instrument which converts into a class of share in the AHC which itself tracks gains on underlying debt securities.

If the fund's strategy is primary lending with the expected returns comprising interest and fees, the funding to the AHC could be through a small amount of ordinary share capital and the rest of the funding through an income sharing loan. This ISL will strip out the underlying income of the AHC less a transfer priced margin. In the event that any equity is acquired on a restructuring, part of the back to back debt could be converted into a class of Equity Tracker Shares which would track that equity. The loan investment and the ISL should be accounted for on an amortised cost basis with FX movements on the investments and hedges cancelling each other out through fair value movements. As mentioned above, potential impairment situations and their accounting and tax implications would need to be addressed.

Where the fund's strategy includes acquiring secondary debt at a discount which could produce material gains, an ISL could be supplemented by a combination of tracking shares and convertible debt the effect of which will be to both shelter those pull to par profits from corporation tax while also extracting them to the fund as capital gain. On that basis, a possible capital structure could be as follows:

- The share capital of UK AHC (assuming a € functional currency) will be split into:
  - A ordinary shares of €1 each (the A Shares);
  - B shares of €1 each (the B Shares); and
  - one or more classes of Equity Tracker Shares of €1 each.
- The A Shares will be entitled to all of the assets, income and profits of UK AHC (after payment of expenses and prior ranking obligations) apart from amounts attributable to the B Shares and the Equity Tracker Share.
- The B Shares will be entitled as a priority to their subscription amount plus the profits realised by the AHC in respect of pull to par gains on secondary debt. The B Shares will be in the last loss position in relation to the assets of the AHC.
- Each class of Equity Tracker Share will track the performance of equity, option or warrant investments by the AHC.
- Alongside the B Shares would be convertible loan notes (the CLNs). These would be denominated as €1 each and will convert on a 1 for 1 basis into B Shares. They will have priority to the ISL. The CLNs would strip out the vast majority of the pull to par gains in a form which should be treated as capital gains for UK tax purposes.
- Equity gains would be repatriated by redemption of the relevant class of Equity Tracker Shares.

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