

MACFARLANES

UK asset holding company regime

Insights into the new regime

March 2023

Introduction

In April 2022, the UK introduced the qualifying asset holding company (QAHC) regime which makes it easier for investment funds to base their under the fund investment holding structures in the UK, rather than Luxembourg or Ireland.

This guide provides a walk-through of the rules and published guidance as well as sharing our experience implementing the rules in private equity and credit fund structures. The guide does not seek to cover real estate aspects. All legislative references are to Schedule 2 Finance Act 2022 unless otherwise stated.

If you would like further information or specific advice please contact:



Damien Crossley
Partner

DD +44 (0)20 7849 2728
damien.crossley@macfarlanes.com



Mark Baldwin
Partner

DD +44 (0)20 7849 2603
mark.baldwin@macfarlanes.com



Rhiannon Kinghall Were
Head of Tax Policy

DD +44 (0)20 7791 4131
rhiannon.kinghallwere@macfarlanes.com



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Conditions for entry into UK QAHC regime

The UK QAHC regime is a bespoke regime that, provided certain conditions are met, switches off and adapts certain aspects of the UK tax system to mitigate the barriers that have prevented the widespread use of UK vehicles as under the fund asset holding companies.

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

A company will be a QAHC if:

- it is UK tax resident;
- it meets the ownership condition;
- it meets the activity condition;
- it meets the investment strategy condition;
- it is not a UK REIT or a securitisation company;
- 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 UK tax resident company can enter the regime. HMT has been separately consulting on allowing offshore companies to reincorporate in the UK. The Government is committed to the policy (as stated in an April 2022 response to the consultation) however, no timescale or detail has been provided to conclude how this will develop.

There are three potential benefits of using an offshore incorporated company as a QAHC:

- manage stamp duty/SDRT exposure on a transfer of shares in the QAHC;
 - access a more facilitative corporate law regime, making it easier to do share buybacks from the QAHC; and
 - allow all share buybacks to be offshore source gains (as opposed to the pro-rated regime for UK incorporated companies).
- While managers may be nervous about using (for example) a Channel Islands incorporated QAHC to face off against certain non-UK investee jurisdictions, we may see managers considering a double QAHC structure with a UK resident and incorporated bottom QAHC and a UK tax resident but Channel Islands incorporated top QAHC.



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Ownership condition

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

The 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

by at least

70%
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 a QAHC, that will disqualify the entire company from the regime, not just the assets tracked by those securities.



Identifying holders of relevant interests

The ownership condition limits the relevant interests held by non-Category A investors to 30%. To determine if more than 30% of relevant interests in a QAHC 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 QAHC 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:

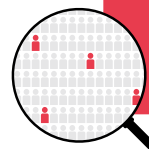
- i. directly;
- ii. partly directly and partly indirectly through another person or persons who are not QAHCs; or
- iii. solely through one or more QAHCs.

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 holder for the purposes of the directly and indirectly rule);
- with effect from 20 July 2022, a person is treated as holding an interest directly if they hold an interest solely through one or more QAHCs; and
- a person is taken as holding 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 QAHC 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 test (non-Category A) 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 ensures that the full direct and indirect interest of a non-Category A 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 as 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 a QAHC 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).



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Category A investors and qualifying funds

The ownership condition requires that persons other than Category A investors must not exceed 30%. The most common route through will be to rely on ownership by a “qualifying fund”.

Category A investors include:

- a QAHC;
- a qualifying fund (see below);
- an intermediate company;
- a UK public authority;
- a relevant qualifying investor, which includes:
 - a UK or overseas pension scheme;
 - a UK or non-UK authorised life insurance (or similar) company;
 - an entity benefitting from sovereign immunity;
 - a UK REIT;
 - a non-UK resident property rich company; and
 - a charity not connected to individuals managing the QAHC.

A qualifying fund is defined as:

- a CIS (or an AIF (that is not a CIS only by reason of it being a body corporate)*) which meets the genuine diversity of ownership (GDO) condition;
- a CIS or AIF which is “not closed”; or
- a CIS or AIF which is 70% controlled by Category A investors (the “70% control test”).

* Change backdated to 1 April 2022 with effect from the date of Royal Assent of the Second Finance Act 2023.

Points to note

- A co-mingled partnership fund will likely be a collective investment scheme (CIS) and an alternative investment fund (AIF).
- A “fund of one” may be neither an AIF or CIS (or be both), depending on the circumstances.
- The non-close test requires the fund to be quite broadly held. Funds with a small number of investors are unlikely to be non-close. These vehicles (including all funds of one, assuming a CIS and/or AIF) will need to satisfy the 70% control test if they do not satisfy GDO.
- In determining whether a fund is 70% controlled by Category A investors it is necessary to look at voting power and entitlement to income distributions and rights to assets on winding up. Measuring the votes of investors (particularly in a LP fund) is not that obvious as they rarely get to vote and those votes might not be said to control the fund. In the guidance, HMRC acknowledge that limited partners may only have voting rights in relation to limited matters, however the votes that they do potentially get to exercise should be applied for this test.
- Any carried interest (which will almost always not be held by Category A investors) is taken into account in the 70% test (as it is in the non-close test). In practice, this will mean that if relying on the 70% test, it is likely all or almost all of the investors in the fund will need to be Category A. A Category A investor can include a qualifying fund and so, as well as funds of one, the 70% test may be used to qualify master funds where there are qualifying feeder funds (which satisfy GDO). This use will be less relevant when multi-fund arrangements can benefit from the GDO test (not just individual entities).
- If a partnership fund of one is not a CIS or AIF, it could still hold an interest in a QAHC pursuant to the partnership trace through rules discussed later in this guide.

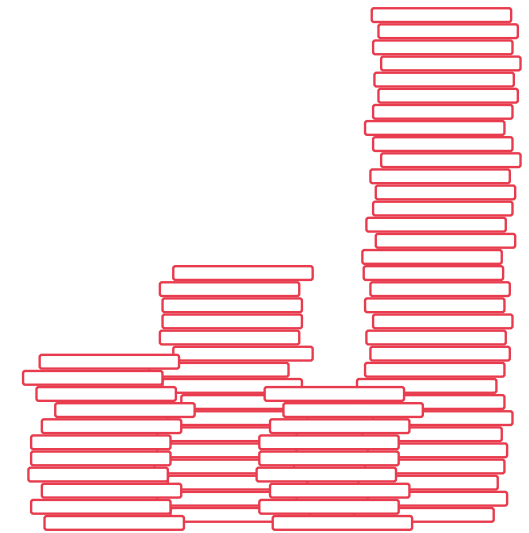


Category A investors and qualifying funds (continued)

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/70% control test analysis and need not continually monitor its 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 general guidance on the application of the GDO condition in a variety of situations including QAHCs, extracted in part on pages 11-13, is helpful in this regard. As can be seen, with the help of HMRC's guidance, it should be possible for most widely held private funds to be qualifying funds on the basis of the GDO condition.
- The Government is currently undertaking a review of the application of the GDO test to closed-ended alternative funds as the use of the GDO condition has expanded. This might result in changes to the guidance currently relied upon.
- New rules will be brought in via the Finance Bill 2023 for multi-fund arrangements. This will effectively allow a master fund to satisfy GDO by reference to its feeder funds and also allow funds to satisfy GDO by reference to parallel funds.
- Under the originally enacted rules, funds which were bodies corporate could not rely on GDO. This included both truly corporate funds but also partnership funds where the partnership was a body corporate under local law. Rules are proposed in the Finance Bill 2023 that extend the GDO route to AIFs where the only reason they are not a CIS is that they are a body corporate. When introduced, this change will be deemed to have always had effect.



Is the fund a CIS or an AIF?

A fund for the QAHC regime means either a collective investment scheme (CIS) or an alternative investment fund (AIF). These are regulatory terms rather than tax terms but it is expected most funds will qualify under one of these categories.

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. Following discussions with stakeholders, the QAHC legislation has been updated to allow AIFs that would be a CIS only for the fact they are a body corporate to be classified as a qualifying fund.

AIF

An AIF is defined in regulation 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. This sets out the tracing rules in determining the owner of relevant interests in a QAHC. There are different tracing rules for the non-close and 70% control test.

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 (or be treated as) a direct shareholder in an QAHC.

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

In determining the relevant interests through a transparent entity, priority entitlements to profits or gains for managing the investments of the partnership are ignored.

Where company shares confer voting power, and those shares are held through a transparent entity (such as a partnership or trust), the voting power is treated as a power of the partners divided between them in the same proportions as they would be entitled to profits arising from securities.

As stated earlier, 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), where the carried interest is held by persons in connection with the provision of investment management services (IMS).

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 QAHC to satisfy the ownership condition if it is a qualifying fund or an intermediate company, each as defined. In applying the non-close test in relation to a fund, corporate investors are not traced through. However corporate investors are traced through for the purposes of the 70% control test under the qualifying fund rules.

Intermediary companies

An intermediary company may qualify as a Category A investor. An intermediate company is defined as 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 only looks at economic rights as references to voting rights are disapplied.

What this means is that, where a QAHC is owned by a company, if that company is not a qualifying fund, it must be 99% owned by Category A investors.

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 likely 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).

Genuine diversity of ownership (GDO) condition

A fund which is a CIS or an AIF that is not a CIS only by reason of it being a body corporate that satisfies the GDO condition is treated as a qualifying fund, and therefore a Category A investor. 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 QAHC regime. This is currently being updated to be more relevant to private funds.

To be treated as GDO compliant, a fund vehicle must meet conditions A, B and C.

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.

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."*

In general, a new fund should not face any issue with meeting this requirement assuming it has been decided that a QAHC is going to be used to and there is an awareness that the PPM or other marketing materials include the appropriate statements.

It is not clear the QAHC regime will change expectations around what is meant by marketing documents being "available" to HMRC. As a minimum it will be necessary to have them ready, but generally it would not be expected that the documents need to be submitted to HMRC.



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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:
 - limits investors to a limited number of specific persons or specific groups of connected persons, or
 - 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."

The intention behind Condition B is to exclude funds that limit investment to a select group, which might be as a result of terms (for example management fees or minimum investment thresholds) that have a discriminatory effect. As the guidance states, this should not prohibit normal commercial terms.



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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.



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, *“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

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

A fund vehicle will be a qualifying fund if it is not “close”. 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 15 and 16).

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.

A company is generally close under section 439 CTA 2010 if it is controlled or it is majority economically owned by five 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 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 “participator” 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. Creditors in respect of normal commercial loans are not treated as participators for these purposes.

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

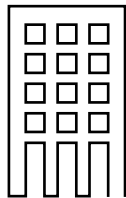
- the greater part of the share capital or issued share capital of a company;
- the greater part of the voting power in the company;
- so much of the issued share capital of the company as would, on the assumption that the whole of the income of the company were distributed among the participators, entitle 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.

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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 or 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.



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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 12 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 in Sch 5AAA TCGA 1992.

- 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.

Application

- Most importantly for us, partners in a partnership are not treated as 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.



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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 of 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, in our example waterfall the total carried interest entitlement would be 20% (not the 100% it could be during the "catch-up" phase).



Eligibility criteria

Operational aspects of the regime

Application

Points to note

While the non-close test is not for the faint-hearted, some funds with a large investor base will comfortably meet the test, albeit with ongoing requirements to monitor the status of the fund.

The test as to whether a fund is close or not is applied separately in relation to each parallel fund within a single overall fund structure. There is no aggregation for the purposes of the non-close test as there will be for the GDO test (following Royal Assent of the Finance Act 2023).

One disadvantage of the 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.

For the first two years of entry in the QAHC regime, there is a grace period whereby a QAHC may treat itself as having met the ownership condition if it reasonably expects that it will do so before the two years is up (or such greater period as is negotiated with HMRC). This might be useful for new funds that are expecting to attract new

investors – even if they currently do not meet the close test, if they expect they will after the new investor commitments are formalised, it is possible to start to benefit from the regime immediately. Although this grace period in theory applies to all of the methods of meeting the ownership condition, in practice it will probably only apply in respect of the non-close test or 70% control test, as GDO should be met once a fund is closed.



70% control test

The qualifying fund definition is also met if the fund is 70% controlled by category A investors.

A fund (again defined as a CIS or AIF) is 70% controlled by category A investors if one or more of them directly or indirectly possesses:

- 70% or more of 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;
- so much of the fund as would, on the assumption that the whole of the income of the fund were distributed among persons with interests in the fund, entitle that investor or those investors to receive 70% or more of the amount so distributed; and
- such rights as would entitle that investor or those investors, in the event of the winding up of the fund or in any other circumstances, to receive 70% or more of the assets of the fund which would then be available for distribution among persons with interests in it.

Points to note

These tests are the same as the close company tests with the following differences/ points to note:

- while the question of whether investors have voting power is not critical to the close test, it is necessary to conclude that they do for the purposes of the 70% control test and then to determine how to measure it. While a fund will usually be controlled by a manager/ general partner, investors will usually be given voting rights on certain matters and HMRC regard that as both sufficient and the voting power to be measured in this context;
- while for the close test there is no tracing through corporates, for the 70% control test it is possible to trace through any number of body corporates (although the rules do not tell you how to do so where the body corporates have more complex ownership structures);
- while for the close test, you trace through all partnerships, for the 70% control test you do not need to trace through a transparent CIS that meets the genuine diversity of ownership condition;
- like the close company test, in determining economic rights, it is necessary to ignore any interest any person has as a creditor of the fund in respect of a normal commercial loan; and
- the fixed carry percentage used in this test ignores PPS and the votes follow the economics provisions set out above.

It is going to be difficult for a fund to be a qualifying fund under the 70% control test by reference to direct investors. This test is likely to be limited to (i) funds of one (or two or three); and (ii) where there are feeder funds which satisfy the GDO condition (it is necessary to trace through feeder funds which do not satisfy the GDO condition with the result that all investors are effectively direct investors).



Activity and investment strategy conditions

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

Activity condition

The activity condition states that the main activity of the QAHC 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 QAHC'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, 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 listed or traded, or other interests that derive their value from such securities. With effect from the date of Royal Assent of the Finance Act 2023, a revocable election can be made to treat the investment strategy condition as met notwithstanding the holding of listed securities, however the election turns off the dividend exemption with respect to listed securities such that the QAHC will pay corporation tax on dividends from listed securities while the election is in force.

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).
- There is no legislative basis for determining trading versus investment however guidance has been published by HMRC to provide some comfort specifically for credit strategies. We expect most credit strategies, will be considered investment in nature.
- The terms "ancillary" and "substantial extent" are not defined in the legislation. HMRC guidance suggests that "substantial extent" is determined by looking at whether potential investors would have regard to those activities when making a decision to invest or not.

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. The development of this condition resulted in the removal of more complex tracing provisions.
- The legislation does not articulate what the investment strategy must consist of, but it is clear that it is the QAHC's investment strategy, rather than the fund's strategy. It is not entirely clear how one should determine the QAHC's

investment strategy other than by looking at what it owns, however if a strategy is set out, HMRC have confirmed that not explicitly ruling out the acquisition of listed shares in the strategy should not mean you have a strategy of acquiring listed shares.

- Unless a "deemed compliant" election is in force, 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 or stake-building prior to a takeover bid). 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 QAHCs 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.
- As stated above, it is proposed that Finance Act 2023 will introduce an election that means where the QAHC holds listed securities it is possible for the QAHC to treat the investment strategy as having been met. The cost of this is to turn off the dividend exemption in respect of listed equities. The denial of the dividend exemption applies to all listed securities held by the QAHC, irrespective of ones that may have been acquired as part of a public-to-private transaction.



Main tax benefits of the UK QAHC regime

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

Key tax benefits of the UK QAHC 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 (and furthermore, 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. Furthermore, such a transfer does not attract stamp duty.

Entry, exit, administration and other provisions

In order to make use of the QAHC regime, it is necessary to elect into the regime. There are a number of considerations to take into account when electing into the regime as well as the administration of the notification requirements.

The QAHC 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 into the regime but for the fact that the shares have been held by the company for less than 12 months, the SSE is extended and continues to apply if the QAHC 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 and encourage 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 land, qualifying 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 in certain scenarios.

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.

Groups

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

QAHCs treated as close companies

Even if it would not otherwise be, a QAHC is treated as a close company under para 37 meaning that rules such as the loans to participators and other anti-avoidance rules apply to it.

Exchange gains

The loan relationship and derivative contracts (exchange gains and losses using fair value accounting) regulations (also known as the disregard regulations) are amended for QAHCs such that stripping out FX gains on back to back debt should not be restricted by the corporate interest restriction rules.



Points to note

Other provisions (continued)

Application of the corporate interest restriction rule

It is worth noting, despite modifications the QAHC is a normal company for corporation tax purposes, and so for example, the corporate interest restriction will apply to QAHCs with certain modifications. However, as all profit on debt is treated as interest or interest equivalent in the UK (even profit relating to market discount), these rules should not cause an issue in the credit fund context.

Anti-hybrid rules

The QAHC regime switches off the application of certain aspects of the hybrid mismatch rules. The simplifications are in relation to hybrid instruments, so hybrid entity rules would still need to be considered in full. However, following the 2021 changes to the hybrid entity rules, these should be manageable in most fund structures.

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 QAHC entitlement to input tax recovery to the extent that the recipients of the supplies belong outside the UK.

A UK QAHC 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 QAHC 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.

However using a QAHC below a UK fund with a UK VAT grouped manager may worsen the manager's VAT recovery position compared to a Luxembourg AHC.

Aggregation of portfolio holdings and application to SAO

If the QAHC meets the relevant thresholds it will be necessary to consider a number of provisions, such as the senior accounting officer (SAO) regime, that have not been switched off for the QAHC regime.

Stamp duty

Although a stamp duty exemption is provided in relation to share buybacks, the exemption does not extend to transfers.



Distributions to remittance basis users

The QAHC regime makes special provision to allow investment managers to protect their remittance basis position. 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 QAHC would be UK source even if they derive from underlying non-UK income and gains (i.e. using a UK QAHC 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 QAHC 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.

Eligibility criteria

Operational aspects of the regime

Application

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 gains arise 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 QAHC 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. 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 QAHC regime will allow profits distributed on a share buyback to be returned in a capital form to be taxed as capital gains. We expect this route to be used to repatriate underlying equity gains to investors as capital gains, however where the QAHC is a UK incorporated company a share buyback gives rise to UK corporate law considerations.

Points to note

Ordinarily, for tax purposes, the premium element of a share buyback is treated as an income distribution, rather than a capital gain, irrespective of its underlying source. This is one of the reasons why UK holding companies have typically not been used. The QAHC regime treats both the capital repayment and premium element of the repatriation as capital, and taxes it accordingly in the hands of the investor.

The one limiting factor is the corporate law considerations around distributable reserves. 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 QAHC 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. Distributable reserves are not always in ready supply therefore a non-UK incorporated (but UK tax resident) company located in a more relaxed corporate law environment may be more favourable. It is hoped the Government will consider amending UK company law in due course to encourage UK incorporated companies, as this would be more in-keeping with the objectives of the regime.

In the meantime, other methods could be considered. These include a buyback out of capital or 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.



Comparison of UK and Luxembourg

It is useful at this point to consider how the new UK QAHC regime will stack-up against Luxembourg.

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.

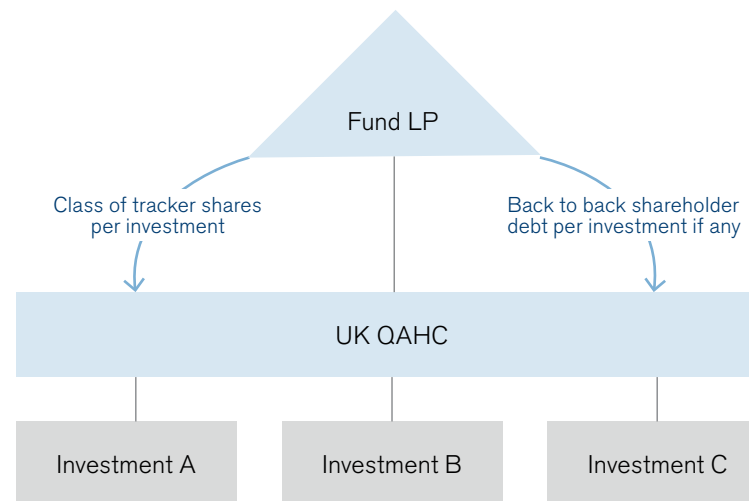
Cons of UK v Luxembourg

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



Application to a typical private equity fund structure

- 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.
- QAHC should just pay tax on transfer priced (minimal) margin on flow through shareholder debt.



Issues to consider

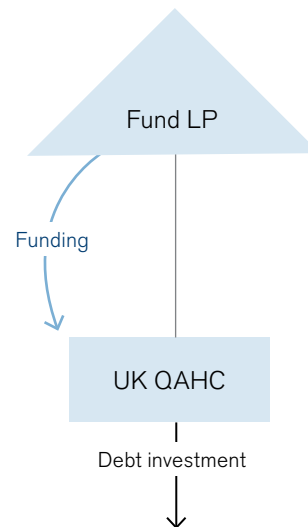
- VAT: ensure no services for consideration are provided by portfolio manager to QAHC (same issue in Luxembourg).

Benefits of UK QAHC 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

- 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 QAHC.



Issues to consider

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

Benefits of UK QAHC 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.

Contacts



Damien Crossley
Partner

DD +44 (0)20 7849 2728
damien.crossley@macfarlanes.com



James McCredie
Partner

DD +44 (0)20 7849 2129
james.mccredie@macfarlanes.com



Alicia Thomas
Partner

DD +44 (0)20 7849 2773
alicia.thomas@macfarlanes.com



Ceinwen Rees
Partner

DD +44 (0)20 7849 2751
ceinwen.rees@macfarlanes.com



Mark Baldwin
Partner

DD +44 (0)20 7849 2603
mark.baldwin@macfarlanes.com



Sophie Donnithorne-Tait
Partner

DD +44 (0)20 7849 2670
sophie.donnithorne-tait@macfarlanes.com



Rhiannon Kinghall Were
Head of Tax Policy

DD +44 (0)20 7791 4131
rhiannon.kinghallwere@macfarlanes.com



Shailen Patel
Head of Accounting Advisory

DD +44 (0)20 7849 2138
shailen.patel@macfarlanes.com

Macfarlanes LLP

20 Cursitor Street London EC4A 1LT
T +44 (0)20 7831 9222 | F +44 (0)20 7831 9607
DX 138 Chancery Lane
macfarlanes.com

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