ALLEN & OVERY

20 Questions on Qualifying Asset Holding Companies (QAHCs)

Speed Read

The Finance Act 2022 (FA22) has introduced a new regime for qualifying asset holding companies ("QAHCs"). The new regime, which came into force on 1 April 2022, offers qualifying companies a wide range of tax benefits, broadly intended to ensure that investors are taxed no less favourably than had they invested in the underlying assets directly.

Although the policy intention behind the new regime was primarily designed to benefit alternative investment holding structures, it offers significant benefits and is expected to be attractive to a wide range of investors and holding structures. The reforms are part of a wider and ongoing drive by the UK Government to allow the UK to compete with other, more established, holding company jurisdictions in a post-Brexit environment.

1. Why do we need a new regime, and how did we get here?

Most alternative investment funds will comprise a main fund vehicle into which investors will pool their capital (sometimes through other "feeder" vehicles). The fund itself may take many forms, but is most commonly established as a tax transparent limited partnership. In addition, the fund will typically have a number of special purpose vehicles sitting underneath the fund itself performing various holding functions. These holding vehicles are important, as they help to silo and segregate risks and liabilities, allow for ring-fenced financing and hedging, and enable the fund to provide equity incentives to managers and bring in co-investors. The core aim of the new QAHC regime is to encourage managers to establish these holding companies in the UK.

In recognition of the importance of the UK asset management sector (being the largest in Europe and the second largest globally), the Government announced a consultation at Budget 2020 to explore the barriers that the UK corporation tax system might be creating for the establishment of these companies in the UK and how they might be removed.

There are a number of attractive features of the UK tax system (including a wide treaty network, the broad dividend exemption and the lack of withholding tax on payment of dividends), but it was clear that the UK was not the jurisdiction of choice for many funds in establishing their holding structures, even where the funds themselves were managed from the UK. By far the most popular jurisdiction for establishing these vehicles for European managed funds is Luxembourg, with Ireland also quite common.

An attractive tax regime aims to achieve something approaching "tax neutrality": ensuring that there is no incremental taxation arising in the holding structure compared to a direct investment by the ultimate investors in the underlying assets.

The perceived benefits for the UK in establishing such a regime would include not only the indirect benefits of increased supporting infrastructure, but also ensuring that fund managers would not be tempted to shift their management services overseas.

After an extensive period of consultation, and various iterations of the draft provisions, the final version of the legislation was included in FA22 and the new vehicle is available from 1 April 2022. HMRC has also published supplemental guidance on its approach to the regime in its investment funds manual (at **IFM40000 et seq**).

2. What does the QAHC regime cover (and what does it not)?

The QAHC regime applies only to the investment business of company in so far as it relates to the holding of certain ring-fenced assets. The classes of ring-fenced assets comprise qualifying shares, loan relationships and overseas property (including related derivative contracts).

"Qualifying shares" are defined, broadly, as any shares that do not derive at least 75% of their value from UK land and for these purposes include units in a unit trust. The regime will therefore not apply to UK property or shares in a UK property-rich company.

The UK Government's view was that the existing Real Estate Investment Trusts (REIT) regime already offers an efficient structuring solution for funds investing in UK property, especially given additional reforms to the REIT regime in FA 2022.

Although the QAHC regime does not apply to assets outside the ring-fence, a QAHC is still permitted to hold such assets (subject to the activity and investment strategy conditions being met). The company is treated for tax purposes as being comprised of two separate and distinct notional entities, one qualifying and one non-qualifying.

3. What are the key tax benefits of the regime?

Exemption from tax on gains

First, gains on disposals by a QAHC of ring-fenced assets are not chargeable to UK tax (*paragraph 53, Schedule 2, FA22*).

Whilst the UK already has the substantial shareholding exemption as a form of relief on share disposals, the exemption for a QAHC is more straightforward and is achievable without having to meet the various conditions that the substantial shareholding exemption would require. This could be useful, for example, where a debt fund holds small equity investments alongside its debt which fall below the 10% substantial shareholding threshold or where the target company carries on non-trading activities.

This exemption sits alongside the existing dividend exemption in Part 9A of the Corporation Tax Act 2009, meaning that returns from investments in qualifying shares should generally be exempt from UK tax in the hands of the QAHC.

Exemption from tax on overseas property income

There is a broad exemption from tax on overseas property income, provided that it is taxable in a foreign country (ie the income cannot be treated as exempt or chargeable at a nil rate in that foreign country) (*paragraph 52, Schedule 2, FA22*). This exemption also covers debt or dividend incomes that relate to overseas property income, but if that debt or dividend partly relates to something else then the exemption should be applied proportionately.

No withholding taxes

Interest which is paid by a QAHC is not subject to UK withholding tax (*section 888DA, Income Tax Act 2007*). This means that proceeds can be repatriated to investors without withholding and without the need to apply to HMRC for treaty relief or obtain quoted Eurobond listing. Again, it needs to be considered alongside existing UK tax law principles and the fact that there is no withholding on dividends either.

However, it should be noted that funds will still need to consider any local law requirements of the investee jurisdiction with respect to payments received by the QAHC on its investments. Many European jurisdictions may require evidence of tax residency, which would need to be applied for, and in the UK this process can be cumbersome. Some jurisdictions do impose withholding tax on returns to UK investors (especially as that they can no longer access the benefit of EU Directives). Notable examples are payments of dividends by German or Italian companies to a UK parent, which are subject to 5% withholding tax.

Flexible means of repatriating income

Deductibility is a key concern for funds in achieving tax neutrality. Under normal corporation tax principles, there are rules which deem interest on securities that have certain “equity-like” features to be non-deductible. Those rules are relaxed for QAHCs so that, in certain circumstances, interest payments on profit-participating and limited recourse debt (amongst others) may be deductible.

This is particularly significant in the context of returns on debt investments made by a QAHC. These returns are not exempt in the hands of the QAHC and so are taxed broadly in line with the ordinary loan relationship rules. By enabling the QAHC to claim deductions for profit-participating debt, it is likely to reduce the taxable profits to just a small margin. The margin will be calculated on the basis of transfer pricing principles. Given that the effect of a profit-participating loan is to pass most of the investment risk onto the lender, the arm’s length return arising to the QAHC would typically be just a few basis points.

Buyback and redemption of shares

The new regime allows QAHCs to repatriate capital by way of share redemption, repayment or buy-back without being subject to the deemed distribution rules, meaning that premiums received by individuals can be taxed as capital. This is subject to some exceptions, including where the payment relates to employment-related securities.

There is also a general exemption from stamp taxes on a transfer to a QAHC of its own shares and loan capital, subject to conditions.

No adverse impact for non-dom investors

The receipt of income or gains from a QAHC by non-UK domiciled individual investment managers who are taxed under the remittance basis are not necessarily UK source. Instead, individuals can effectively trace through the QAHC so that the income and gains received by the individual reflects the underlying mix of UK and non-UK income and gains of the QAHC.

4. How will individual investment managers be treated?

The Government recognised during the consultation process that the QAHC regime would not gain popularity with alternative funds unless it provided an attractive outcome for individual managers. Ultimately, investment managers will often be closely involved in designing the fund structure, and they will be keen to know how they will be treated for tax purposes on receipt of their carried interest and other incentivisation.

Traditionally, carry participants pay only a modest initial amount to subscribe for their carried interest. The tax treatment has been quite controversial in several countries, with many arguing that it should simply be taxed as employment income. However, in the UK, carried interest can still benefit from the lower tax rates available for capital gains rather than employment income, provided a number of conditions and anti-avoidance rules are satisfied. The new QAHC regime allows for returns to be paid up in capital form by way of a redemption of shares, which would facilitate that treatment (subject to the specific carried interest rules still being met). Having the returns paid in capital form is not enough in itself to benefit from the lower CGT rates (currently at a maximum of 28%), but it is a necessary pre-condition, so without it the regime would have been significantly less attractive to carry holders.

5. What about the VAT treatment?

The VAT exemption that applies to investment management fees in the UK is much narrower than the corresponding exemption available in Luxembourg and some other jurisdictions. The UK Government recognises that the VAT treatment of management fees is a significant factor and is considering the position further, although they have already stated that they will not look at a VAT zero-rate for such fees.

As it stands, the difference in the scope of the fund management exemptions gives rise to a potentially helpful VAT arbitrage for Luxembourg funds that are managed by UK managers. There is a degree of nervousness that the VAT review could result in this arbitrage opportunity being removed.

6. Which companies can access the regime?

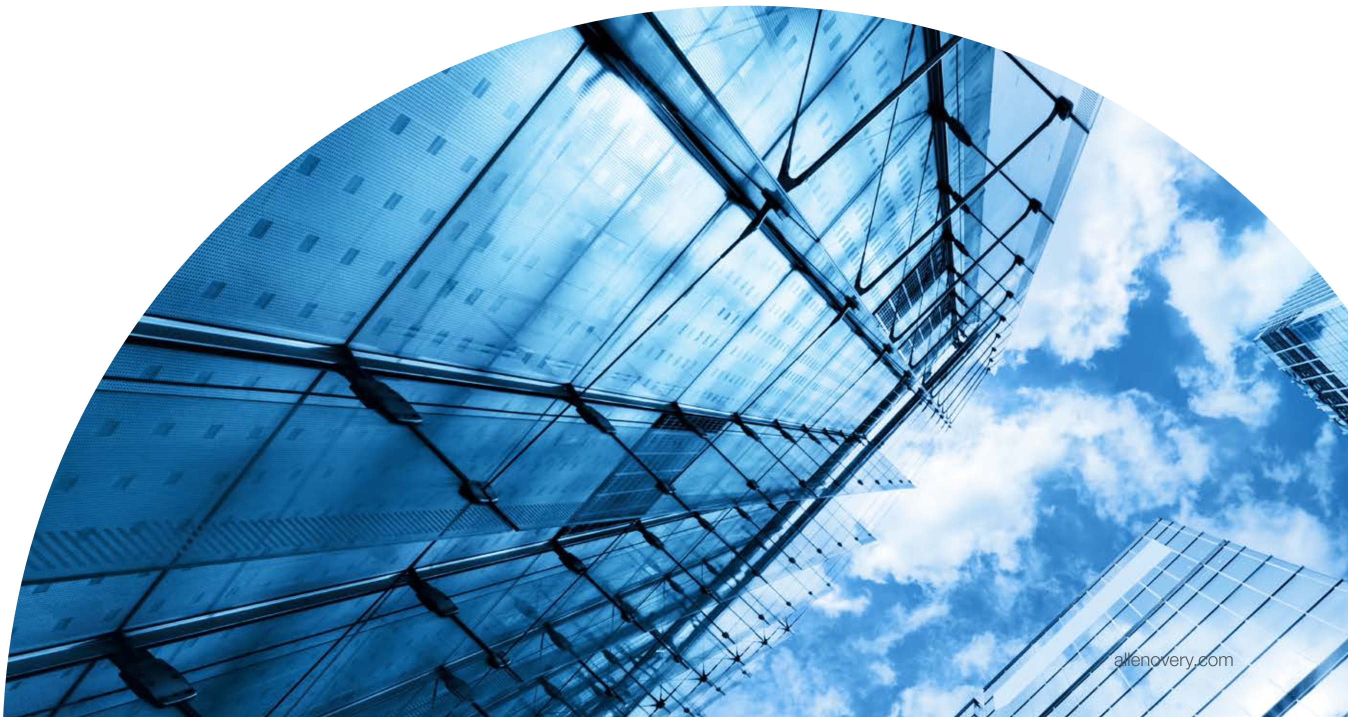
A company must satisfy a series of conditions in order to access the regime. Specifically, the company must:

- Be UK resident. Non-UK incorporated and resident companies can become UK resident in order to access the regime.
- Meet the ownership condition. The ownership condition is the most complex of the conditions and more detail is set out below.
- Meet the activity condition. The main activity of the company must be the carrying on of an investment business, and any other activities of the company must be ancillary to the investment business and not carried on to a substantial extent. In its guidance, HMRC states that whether any particular activity will constitute an investment or trade will depend on the particular facts and that HMRC's general guidance on the meaning of trade and financial trading should be consulted (**IFM40260**). Given the critical importance of the distinction in this context, there have been calls for HMRC to publish further, more directional guidance, especially in relation to credit strategies.
- Meet the investment strategy condition. The company's investment strategy should not involve the acquisition of listed or traded securities, or interests deriving their value from such investments. A narrow exception from the prohibition applies in circumstances in which the acquisition is made for the purposes of facilitating a change in control of the issuer with the result that the securities cease to be listed or traded (*paragraphs 2 and 13, Schedule 2 FA 2022*).
- Not be a UK REIT. This requirement reflects the UK Government's policy rationale that the REIT regime, with the additional recent enhancements mentioned in question 2 above, offers an efficient structuring solution for funds investing in UK property.
- Not have equity securities listed or traded on a recognised stock exchange or any other public market or exchange.
- Make an entry notification.

(*Paragraph 2(1), Schedule 2, FA22*)

7. Is any minimum amount of capital required?

No. The possibility of requiring the QAHC to have a minimum level of capital or other investment was discussed during the Government consultation stages, but this was abandoned and there is no such requirement.



8. Is satisfying the ownership condition difficult?

The ownership condition is the most complex of the requirements, and in certain circumstances might be difficult to satisfy.

Broadly, the ownership condition requires that at least 70% of the "relevant interests" in the QAHC should be held by Category A ("good") investors. However, the statutory language is rather more nuanced than this, and what the legislation actually requires is that the total of relevant interests held by persons who are not Category A investors should not exceed 30%.

This constitutes an important distinction because of the way in which relevant interests are defined and calculated. "Relevant interests" include voting rights, entitlement to profits available for distribution and assets available on a winding up. Importantly, the largest interest counts.

For example, where a Category A investor is entitled to 60% of the voting rights but only 10% of the profits available for distribution, it is the 60% that will be relevant. The consequence of this is that the total number relevant interests in the company can exceed 100%. The legislation specifically contemplates this (and directs that no variation of the calculation should be made in respect of it).

Further, the calculation must be undertaken in relation to all classes of shares and rights. So, for example, where a non-Category A investor is entitled to 80% of the profits available for distribution in relation to a certain class of shares, it is not possible to be a QAHC.

However, a relevant interest does not necessarily need to be held directly – interests can be tracked indirectly in certain circumstances. In particular, indirect interests can be traced though another QAHC and related companies.

9. What/who are Category A investors?

Category A investors are the "good" investors, and are defined as:

– (Other) QAHCs

– Qualifying Funds (see box to the right)

– Relevant Qualifying Investors (a defined class of persons, including life insurance businesses, non-UK REITS, pension funds and sovereign investors)

– Intermediate companies – defined for these purposes as a company meeting the activity condition and being wholly or almost wholly owned by a Category A investor other than a QAHC (99%)

– Certain public authorities

"Qualifying Funds" are funds that satisfy a diversity of ownership condition, and are any of:

– A collective investment scheme that meets the genuine diversity of ownership condition (**GDO Fund**)

– A fund (either a collective investment scheme or an alternative investment fund) that is not "close" as that term is defined as for Part 10 of the Corporation Tax Act 2010 (basically meaning five or fewer participators), subject to certain modifications, including changes to remove the distorting effect of priority entitlements and catch-up arrangements relating to carried interests.

– A fund (either a collective investment scheme or an alternative investment fund) that is at least 70% controlled by Category A investors

The significant benefit offered by the GDO Fund option is that it does not require on-going analysis of the legal and beneficial rights enjoyed by equity holders. Effectively, it is a one time only requirement. By contrast, the second and third options require continuous monitoring to ensure that the calculations and conditions stay on the right side of the line. This may not be an issue in static structures, but could be more of a problem in a dynamic structure with a series of sub-funds.

The GDO Fund is therefore a neat option for satisfying the ownership requirement, if the circumstances permit.

10. What does meeting the genuine diversity of ownership condition entail?

GDO Funds are defined as collective investment schemes (within the meaning of section 235 of the Financial Services and Markets Act 2000) that satisfy a genuine diversity of ownership test borrowed (with minor amendments) from the Offshore Funds (Tax) Regulations 2009 (*SI 2009/3001*) (**regulations**). Importantly, this option will not be available to closed-ended body corporates, as such vehicles will not qualify as a collective investment scheme.

The GDO requirement focuses on the way in which the fund is marketed. It essentially requires interests in the fund to be marketed and made available widely and the fund terms must not include any provisions which have the effect of limiting to a specific group or deters other investors from investing.

11. What do the requirements for Category A investors mean for fund structures involving carried interest?

Carry participants will generally be private individuals and so will not qualify as "Category A" investors. As a result, it will be important that the QAHC track their ownership proportions if they are participating directly in the QAHC. The same also goes for management participation in a private equity transaction.

Most structures involving carried interest would involve the carry holders investing via the main fund vehicle, rather than directly in the underlying holding companies. As a result, provided that the fund satisfies the GDO conditions, then further detailed analysis on the impact of carry holders on the QAHC conditions should not be necessary.

However, if individuals do participate directly in a QAHC (including incentives for managers of a particular investment), or if there is a carry plan in place in place in respect of a structure which does not have a qualifying fund, then it could become more complex, particularly in circumstances where, over the life of a fund, a disproportionate share of the proceeds of one specific investment is allocated to the carry participants.

12. What are the procedural and compliance issues?

Entry into the regime is not automatic. An entry notification must be made by the company, which should include:

- The company's name and UTR (if any) and, if the company is non-resident at the date of the notification, additional details relating to its residence.
- The date on which it is intended the company become a QAHC (this cannot be earlier than the day after the date of notification or 6 April 2022).
- A declaration that, on that date, the company will satisfy all of the required conditions. However, it is also possible for a company to join the regime even if it does not meet the ownership condition at that date, provided that the company reasonably expects that it will meet the condition within two years. This is likely to be useful for young investment companies.

The effect of entering into the regime is to trigger a new accounting period for the company, and assets entering the ring fence are deemed to be sold and reacquired at market value (*paragraph 17(2), Schedule 2, FA22*). This may trigger chargeable gains. There are no specific exemptions for any tax charge arising at this point, but other, existing exemptions (such as group relief or the substantial shareholding exemption (**SSE**)) can be used, if available. The SSE is also tweaked for these purposes so that it can apply even if the usual 12-month holding requirement is not met at the time of the deemed disposal, provided that the QAHC continues to hold the shares for at least 12 months and the other conditions would otherwise be met (*paragraph 17, Schedule 2, FA22*).

13. Are there any ongoing obligations?

QAHCs are required to take reasonable steps to monitor the ownership condition (*paragraph 12, Schedule 2, FA22*). In its guidance, HMRC emphasises that this is an ongoing obligation and that a determination of what steps are reasonable or not depends on all the facts and circumstances of the case (**IFM40250**). Where the QAHC is wholly owned by a GDO Fund, ongoing scrutiny is effectively unnecessary. By comparison, the position will be very different in the context of a company owned by a relatively small number of significant investors.

There are also certain, additional, information requirements. QAHCs are required to submit a QAHC information return to HMRC in relation to every accounting period for which it is a QAHC. As well as the name and UTR of the QAHC, the return must include details of:

- Persons providing investment management services to the QAHC
- Approximate market value of assets within the ring-fence business
- Proceeds from disposals of assets
- Payments made by the QAHC on redemption, repayment and purchase of own shares.

14. What happens if conditions are breached?

The starting point is that a company will cease to be a QAHC immediately after ceasing to satisfy one of the conditions (*paragraph 29(1)(2), Schedule 2, FA22*). Further, the company is required to notify HMRC of any breach of the conditions as soon as reasonably practicable after the breach (*paragraph 26(1), Schedule 2, FA22*).

However, in certain circumstances, a breach can be overlooked. This depends on which condition has been breached, the nature of that breach (in particular, whether the breach was deliberate), and whether a "cure period" applies.

In the context of the activity condition, a breach can be ignored if the breach is not deliberate, the QAHC has notified HMRC of that breach, and the QAHC remedies the breach as soon as reasonably practicable.

Cure periods apply only in the context of the ownership condition and, similarly, allow less serious breaches of the ownership condition to be overlooked. A cure period can apply to breaches of the ownership condition where the relevant interests held by non-Category A investors in the QAHC (or in any class of shares in the QAHC) does not exceed 50%, the breach is not deliberate and the QAHC is not in breach of its obligation to take reasonable steps to monitor compliance. Where a cure period applies, the breach can be ignored provided that the QAHC remedies the breach before the end of the cure period (90 days or such longer period as is agreed).

The statutory provisions do not contemplate any circumstances in which a breach of the investment strategy condition can be ignored.

15. How does a QAHC exit the regime?

If it wishes to leave the regime, a QAHC can make an exit notification to HMRC, specifying the date on which it intends to leave (this cannot be earlier than the date of the notification) (*paragraph 25, Schedule 2, FA22*). As on entry, exiting the regime triggers a new accounting period; previously ring-fenced assets will be rebased to market value.

In certain circumstances, companies can take advantage of a two-year wind-down period. Broadly, this allows a company to continue to take advantage its QAHC tax treatment, even though the ownership condition has been breached, where the company intends to cease its QAHC ring fence business as soon as reasonably practicable and is winding down its business to this intent.

16. What is the significance of ATAD 3?

ATAD 3 is the EU's latest proposed anti-tax avoidance Directive which targets aggressive tax planning techniques linked to the use of shell companies. It introduces reporting obligations and minimum substance requirements which, if not met, could lead to the denial of tax treaty benefits and EU tax Directives.

The concept of "substance" will already be familiar to most funds operating EU holding company structures as many jurisdictions already deny treaty benefits if the income recipient does not have material operating capacity in its home jurisdiction, such as employees, office space, bank accounts and other similar requirements.

This is potentially significant in context of the QAHC regime because many funds already have large teams in the UK exercising the fund management function, which may make proving substance far easier than it would be in other jurisdictions. This will depend on the circumstances of each fund, as many sponsors already have sophisticated Luxembourg-based platforms. For new funds looking to establish their structures there may also be cost-saving opportunities in setting up operational hubs in regional centres: running fund administration teams in Liverpool or Leeds might be much cheaper than in London or Luxembourg.

17. Who will benefit most from, and be most likely to use, the QAHC regime?

Broadly speaking, the QAHC regime achieves equivalency with other popular holding-company jurisdictions, such as Ireland and Luxembourg. However, in order to access the full benefits of a particular structure, it is necessary to satisfy increasingly onerous and expensive substance requirements in target jurisdictions, even before ATAD 3. This represents a barrier to entry for a fund that does not already have a platform in that jurisdiction. Given how many funds have investment teams based in London, there is a real attraction for those funds to being able to operate holding companies in the UK and rely on the substance organically provided by the investment team.

Many large institutional investors are looking to make investments directly themselves rather than relying on third party investment managers. Often those investors will have their own investment teams in the UK and if the investor satisfies the requirements to be treated as a Category A investor (such as a sovereign wealth fund or pension fund), then they may be able to access the benefits of the QAHC regime.

There may be specific advantages to the UK QAHC regime over Ireland or Luxembourg as a debt-holding vehicle where the debt is distressed or is expected to be sold at a premium, due to the interaction of the UK's loan relationship rules and corporate interest restriction rules as compared to the equivalent provisions in Ireland and Luxembourg. This can be a material factor in structuring discussions and is something we are already coming across in practice.

18. Who won't it appeal to?

Funds that already have a substantial Luxembourg platform may not be as actively interested in the UK QAHC regime, particularly since the basic Luxembourg tax regime does not require that numerous conditions be met on an ongoing basis. The ongoing monitoring requirements may also be off-putting in structures where there are complex management participation and carried interest arrangements impacting the ownership condition.

In addition, for managed account structures, "funds of one" and other structures with small pools of investors, the regime will rely on the status of those investors and so it may not be available in all cases.

Funds that invest primarily in UK real estate, or who carry on a trading activity, are also unlikely to be actively interested in the regime (although there may be circumstances where it is advantageous to establish UK QAHC as the entity that holds shares in the company that is carrying on a trading activity).

19. Is that it for Funds?

In order to anticipate whether there may be further industry reforms, it is worth recalling the context for the current developments. In the 2020 Spring Budget the Government announced that it would undertake a review of the UK's funds regime during 2020, covering direct and indirect tax, as well as relevant areas of regulation, with a view to considering the case for policy changes. The QAHC regime is just one component of this.

The Government is still in the process of reviewing the position on VAT on investment management fees and is currently working towards a consultation, expected to be published soon. This is particularly significant for credit funds, given their limited ability to recover any input VAT.

The Government is also continuing to engage on potential solutions to barriers to investment in long-term, less liquid assets through the introduction of a "Long-Term Asset Fund" (**LTAF**) structure, through new regulatory rules and new types of authorised funds. In its summary of responses on the call for input on the UK funds regime published in February the Government stated that it is continuing to assess the case for any further changes to the way LTAFs are taxed.

The summary identified several other notable areas where the Government is continuing to engage, including:

- A review of the GDO condition
- Considering options to improve the tax efficiency of UK authorised funds (particularly multi-asset funds)
- Considering further reforms to the REIT regime and how it interacts with the QAHC regime
- An HM Treasury, HMRC and FCA working group to progress work on permitting the distribution of capital by authorised funds
- Further work to explore options for the introduction of a new unauthorised contractual scheme fund structure, noting that the tax rules for a new unauthorised contractual scheme are likely to replicate the tax rules for Co-ownership Authorised Contractual Schemes

20. How should I pronounce “QAHC”?

Finally, a crucial but vexed question is how best to pronounce the acronym “QAHC”. Although we do not feel able to advise unequivocally on this issue, we offer our thoughts below.

- **Option A: /kwak/ (quack like a duck):** has the popular vote; useful for duck jokes and already appearing in the public domain; the least controversial option
- **Option B: /kwa:k/ (sounds like spark):** seems to us to be the most obvious phonetically; no clear comedic value, however;
- **Option C: /kweɪk/ (sounds like quake):** a late contender from the left field; does the regime make the earth move for you?

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