BCLP. Client Intelligent

Insights

PROMOTING UK FUNDS – CAN THE NEW QUALIFYING ASSET HOLDING COMPANY COMPETE WITH LUXEMBOURG?

Aug 02, 2021

SUMMARY

This is likely to be a key reflection when considering the details issued in July about the new UK holding company regime for "qualifying asset holding companies" (QAHCs). The new regime is intended to make the UK more competitive as a holding company jurisdiction and is launched as part of a wider review to make UK funds more attractive.

The QAHC has some qualities that compare favourably to a Luxembourg holdco used as an intermediate holding company in an investment structure. Also, the regime is simpler than first proposed, but significantly there is still a condition for entry to the regime relating to ownership of the QAHC. Luxembourg does not have an equivalent, but does this matter?
This blog considers the updated proposals. See our earlier blog for the original proposals

WHAT WILL THE BENEFITS OF THE REGIME BE?

TAX BENEFITS FOR THE QAHC IN RESPECT OF ITS QUALIFYING ACTIVITY

An intention is to support the QAHC as an investor in non-UK land, shares (other than in "UK property rich" companies), debt and related derivatives. Many of the tax benefits apply to this qualifying activity, which is to be ring fenced from other activity.

In respect of the qualifying activity, there will be:

- an exemption from tax on any gain on the sale of non-UK land or an interest in shares (provided they are not in a company that is "UK property rich") – for these purposes an interest in shares held through a partnership also attracts the exemption; and
- an exemption from tax on income derived from non-UK land where the income is subject to non-UK tax. This exemption is helpful as it avoids the administrative hassle of claiming double

tax relief and is more generous than the existing relief. Profits from debt and derivatives relating to the non-UK land business will also be exempt from tax.

An aim of the regime is for the QAHC to have little or no tax in relation to its qualifying activity. As dividends are usually exempt for a UK tax resident company, one remaining issue is around tax on any interest that is received by the QAHC and passed up to an investor in a back to back loan arrangement. Two modifications will be made to the corporation tax rules relating to this issue. One is that a tax deduction for interest dependent upon the results of the business will not be denied a deduction under the distribution rules. Also, the late paid interest rules, which (when then apply) give a tax deduction for interest when it is paid rather than when it accrues, will also be switched off. Similarly, the Government is minded to switch off the hybrid rule which would otherwise deny a tax deduction for payments made on a profit participating loan.

But will all interest paid by the QAHC be deductible? Relevant to shareholder debt the Government will provide guidance on the application of the transfer pricing rules. Also it will consider the application of the corporate interest restriction (CIR) rules to QAHCs further. These rules can also deny a tax deduction for interest paid on debt (including third party debt). Currently, the Government is not envisaging significant changes to this regime, so the CIR regime could still apply to deny a tax deduction for interest. However, it is going to consider introducing some features which may help the application of the CIR rules to QAHCs, such as amending the definition of worldwide group, so that where a QAHC owns several corporate groups, these will not be treated as one group. Once more detail is issued on this, the tweaks to the CIR regime can be considered to see if they go far enough, particularly given the complications that can arise under the CIR regime.

The QAHC will be exempt from withholding tax on interest paid to a person with an equity interest (which would be a shareholder or a creditor of a loan with equity like features). This is in addition to existing exemptions for withholding tax on interest.

RING FENCING VIS A VIS OTHER ACTIVITIES WITHIN THE QAHC

Investment in UK land, directly or indirectly, or intangibles and trading activity will be non-qualifying activity and will not generally benefit from the tax benefits mentioned above. The QAHC will be taxed on income and gains from UK land under the usual rules – see below for discussion of how the QAHC may be used in multi-jurisdictional real estate funds. However, the non-qualifying activity does appear to attract the new exemption from withholding tax for the payment of interest, provided there is some qualifying activity that the lender is interested in.

Losses from the qualifying activity will not be capable of being set off against profits from the non-qualifying activity.

ENTRY AND EXIT FROM THE REGIME

Existing companies electing to be a QAHC could suffer a tax charge on entry into the regime. A QAHC will be treated as selling assets held for the qualifying activity (it is assumed at market value). Reliance on existing reliefs or exemptions will be necessary as there is no special relief against tax on this deemed gain and no deferral of any tax. Similarly, there will be a rebasing at market value of assets held for the qualifying activity on exit from the regime. It is assumed that the regime will treat the deemed sale as occurring immediately before the company leaves the regime, so that, in contrast to the position on entry, the regime's exemptions apply. Once more detail is issued on this, the rules will need to be considered to check that this means that there is no significant tax on exit.

How will the regime deal with breaches of the eligibility conditions and will there be automatic expulsion from the regime for breach? The Government will develop rules to address this, for example it is considering a distinction between a 'serious' breach and a 'minor' breach. There are similar rules already in the REIT regime.

TAX BENEFITS RELATING TO INVESTORS

A UK tax resident individual shareholder will be able to have a gain realised in the QAHC returned to them in the form of capital through a share buy-back. The usual rules on distribution treatment will be switched off so that all of the proceeds returned to the shareholder may be taxed at the lower rates for capital (20% or 28% for carried interest) than for income (at rates of up to 38.1%). Whilst the Government is going to consider how to prevent the regime from being used to defer taxation of income or conversion of it into capital receipts, it looks like full blown streaming rules matching capital/income in the QAHC with capital/income in an investor may be off the table following consultation.

Any share buy-back (whether to individual shareholders or otherwise) will not attract UK stamp duty or stamp duty reserve tax, so this will further assist return of capital to shareholders.

Individual investors in debt will be able to rely upon the existing rules allowing capital to be returned to the investor under a debt redeemed at a premium where the debt is an excluded indexed security.

WHAT STRUCTURES WILL BE ELIGIBLE?

A QAHC is a UK tax resident company that has elected to be a QAHC and which meets four qualifying conditions:

- ownership condition;
- activity condition;
- it is not a UK REIT; and

- none of its equity securities are listed.

Ownership condition

The ownership condition requires broadly that 70% of the equity interests in the QAHC are owned by ‘good’ investors, referred to as category A investors in the draft legislation.

A category A investor is:

- another QAHC (so that you can have chains of QAHCs);
- a fund that is a collective investment scheme (such as a limited partnership) or an alternative investment fund that is diversely held;
- a qualifying institutional investor, i.e. an insurance company carrying on long-term business, sovereign wealth fund, UK REIT or overseas REIT or a qualifying pension scheme or charity; or
- a Minister of the Crown.

Understandably for a generous new regime, the rules for eligibility have additional features. Some points to watch out for are:

- The 70% ownership test is presented in the reverse, i.e. you need to establish that ‘bad’ investors, i.e. persons who are not category A investors, do not hold over 30% of the equity interests in the QAHC directly or indirectly through another QAHC. This approach makes the test quite complex and the rules deserve some consideration as there are a few traps. For instance, an investor’s indirectly held interests are aggregated with any interest it holds directly in the QAHC, including where the indirect interest is held via a partnership. Helpfully, partners in partnerships are otherwise generally ignored and the rules look to the partnership as a direct investor and do not look through it. There are also rules about carried interests (the maximum entitlement counts for the test) and aggregation of connected party interests. Funds may want to look at carried interest arrangements to see how their structuring affects entitlement to QAHC status because individuals will be ‘bad’ investors.
- Equity interests are shares or debt with equity-like features, so if a bad investor is a lender in relation to a profit participating loan, the loan will need to be considered for the 30% test.

Will the ownership condition in practice mean that an existing QAHC will always be sold to a buyer that will satisfy the ownership condition to avoid the QAHC exiting the regime? Given that the QAHC is intended to help a broad range of industries, including private equity, credit funds, infrastructure and real estate funds, this will not be possible across the board. If a sale is associated with an exit from the regime, the parties should be mindful of the rebasing at market value of assets used for the qualifying activity mentioned above in “*Entry and exit from the regime*“.

ACTIVITY CONDITION

In contrast the activity condition is an easier test, which is satisfied when substantially all of the activity of the QAHC is investing funds with the aim of spreading investment risk for investors. This means that any trading activity will need to be insubstantial. The Government is intending to offer more certainty by providing a test for investment activity.

There is no need for any particular proportion of the QAHC's activity to be qualifying, although many of the tax benefits for the QAHC apply in relation to the qualifying activity only.

FURTHER ISSUES

The Government is considering further details of the operation of the rules, including a targeted anti-avoidance rule to stop abuse of the regime.

Significantly, it is also going to consider further the initial proposal for the fund to be independently managed by a regulated manager. However, it has refined its initial thinking on this proposal. Whilst it still requires an independent manager where a fund is required to have a regulated fund manager to meet regulatory requirements, it anticipates that QAHCs owned by institutional investors will not be required to have an independent and regulated fund manager. It needs to consider other scenarios further.

WILL THERE BE MUCH COMPLIANCE?

Inevitably, the QAHC will need to monitor the profile of its owners on an ongoing basis to ensure that it still meets the ownership condition. The Government is also considering a requirement for the QAHC to report a "small amount of information" in its tax return that is "not administratively burdensome". More details will follow on compliance, which the funds industry will be interested in as they will want a simple regime to operate with a low compliance burden.

WHEN IS THIS TO BE INTRODUCED?

The QAHC regime will be introduced from April 2022. The start date will be 1 April 2022 for corporation tax, stamp duty and stamp duty reserve tax and will be 6 April 2022 for income tax and capital gains tax.

HOW WILL THIS IMPACT ON REAL ESTATE FUNDS?

The QAHC can be used in a multi-jurisdictional fund structure. It may provide an attractive alternative to a local property holding company for holding non-UK land given the exemptions for gains and income from non-UK land. Furthermore, although the QAHC will not have any tax benefits for owning UK land, it will be able to hold it or an interest in it. However, some investors (e.g. exempt investors) may be worse off investing in UK land via a QAHC, so it may not be for them. For instance, rent from UK land will be taxable in the QAHC and the QAHC rules assisting the deductibility of interest do not apply to the holding of UK land, so there could be tax leakage. Also, gains on interests in UK land will be chargeable unless an existing exemption applies. Those investors may be better off investing in UK land via a UK REIT. In turn that REIT could invest in non-UK land via a QAHC because REITs are category A or 'good' investors in a QAHC.

The Government is considering further how a REIT will be able to hold an interest in a QAHC and vice versa.

The Government is proposing a first phase of changes to the REIT regime from April 2022, which are considered in a separate blog.

SO HOW DOES IT COMPARE TO LUXEMBOURG?

On the downside, unlike the Luxembourg regime the QAHC regime has an ownership condition and it would appear that there will be a limited requirement for an independent regulated manager in some ownership situations. However, on the upside, the regime is offering an easier route to return capital to individual investors than the partial liquidation work around route used in Luxembourg in relation to a class of shares. It is also offering a tax deduction for results dependent interest, which is similar to Luxembourg. Also the participation exemption, that is the new exemption from tax on a gain on selling shares and the existing exemption for dividends are more generous than the Luxembourg equivalent, which requires the shares to be held for a limited period of time and to be of a particular size.

In short the new QAHC regime deserves consideration given the benefits it offers, particularly as we hit a 25% corporation tax rate in the UK in April 2023.

RELATED CAPABILITIES

- Tax Advice & Controversy
- Real Estate Tax

MEET THE TEAM

Elizabeth Bradley

London

elizabeth.bradley@bclplaw.com
+44 (0) 20 3400 2323

Paul Williams

London

paul.williams@bclplaw.com
+44 (0) 20 3400 2608

Anne Powell

London

anne.powell@bclplaw.com
+44 (0) 20 3400 2162