HM Treasury

The Tax Treatment of Asset Holding Companies in Alternative Fund Structures

Government response and second stage consultation

December 2020

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Executive summary

At Budget 2020, the government announced a consultation on the tax treatment of asset holding companies in alternative fund structures.

Three important themes arose from the consultation responses.

First, respondents suggested that the scale of the UK's asset management sector, its good infrastructure and skilled workforce would make this a competitive location for asset holding companies (AHCs) if barriers in the UK tax system could be addressed.

Second, respondents said that the establishment of AHCs in the UK could bring economic and fiscal benefits, primarily by bolstering the asset management sector and creating additional jobs in associated service sectors.

Third, respondents set out areas where the UK tax rules currently create barriers to the establishment of AHCs. Many agreed with the suggestion that the government address these barriers through a new regime for AHCs. Respondents also proposed changes to the UK's existing Real Estate Investment Trust (REIT) regime, to better allow UK REITs to serve as AHCs for investment in real estate.

The government has carefully considered the responses and believes that there is both a clear policy justification and a strong economic and fiscal case for reform in this area.

It is therefore launching a second stage consultation on detailed design features of a new regime for AHCs. This will aim to deliver an appropriately targeted, proportionate and internationally competitive tax regime for AHCs that will remove barriers to the establishment of these companies in the UK.

The consultation will also consider targeted changes to the REIT regime, where these could have immediate benefits in making the UK a more competitive location for holding real estate assets.

Chapter 1
Introduction

1.1 At Spring Budget 2020, the government announced that it was pursuing a review of the UK funds regime, covering taxation and relevant areas of regulation, to ensure the ongoing competitiveness of this fundamental element of the financial services sector. The review encompasses a call for input, which will be published shortly, and two supplementary workstreams.

1.2 The first of those workstreams was a review of the VAT treatment of fund management fees, which the government intends to take forward in 2021. The second was a consultation, 'Tax treatment of asset holding companies in alternative fund structures', which was launched on 11 March 2020 and closed on 19 August. This sought to understand whether there were targeted tax changes that could help to make the UK a more competitive location for AHCs.

1.3 AHCs are companies used as intermediate entities in investment fund structures. Their role is to facilitate the flow of capital, income and gains between investors and underlying investments.

1.4 The government understands that, despite the wider strengths of the UK as a financial services hub and despite the commercial benefits identified by industry to locating these entities alongside UK fund management activities, there are barriers in the tax system to the establishment of AHCs in the UK.

1.5 The consultation looked to improve the government's understanding of AHCs, the fund structures in which they are commonly used, the commercial drivers for their location and the fiscal and economic benefits that they bring to the jurisdiction in which they are located.

1.6 It also explored the barriers that the UK tax system might be creating for the establishment of AHCs in the UK, the merits of taking steps to remove these barriers and the different options to do so.

1.7 Chapter 2 of this document summarises the responses put forward during that consultation and is followed by the government's response, in chapter 3. The government believes there is a strong case for change and is launching a second stage consultation, to help develop legislative changes that will make the UK a more competitive location for AHCs.

1.8 Chapter 4 seeks views on the detailed design features of a new regime for AHCs. The approach set out will be subject to further development, and responses will help refine regime rules.

1.9 In addition, chapter 5 seeks views on targeted changes to the REIT regime.

1.10 Chapter 6 sets out a full list of questions for this second stage consultation.

1.11 The government is grateful to all those who contributed their views during the first consultation, especially given that many sectors with an interest in this policy have been affected by COVID-19. We received written responses from 38 stakeholders and held a number of virtual meetings. A list of all respondents can be found in Annex A.

1.12 Information on how to respond to this second stage consultation on the delivery of a new tax regime for AHCs, as well as on targeted changes to the REIT regime, can be found below.

Timing

1.13 The second stage consultation will run from 15 December 2020 to 23 February 2021. Draft legislation will then be published during 2021, allowing for a period of technical consultation ahead of its inclusion in the Finance Bill.

How to respond

1.14 Representations made online are preferable and emails can be sent to ukfundsreview@hmtreasury.gov.uk.

1.15 Representations sent by email should be sent as an attachment that can be opened in Microsoft Word.

1.16 Representation by mail can be sent to:

Asset holding companies consultation

Corporate Tax Team

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

Chapter 2
Summary of responses

2.1 This chapter summarises the main points raised in response to the questions posed in the consultation published on 11 March 2020 (the 'March 2020 consultation').

Understanding the policy concern

Question 1: What role do AHCs perform within alternative fund structures? What are the commercial / tax benefits, what advantages do they offer versus direct investment?

Question 2: To what extent are AHCs prevalent in other funds or pooled investment structures?

Question 3: What do you consider to be the main fiscal and economic benefits to the UK – both direct and indirect – of greater AHC domicile? Can you support this with any quantitative evidence?

Question 6: What impacts have recent developments in the international tax landscape had on determining where to locate an AHC? How have asset management firms so far responded to these developments?

The role of AHCs

2.2 Respondents suggested that a wide range of investment fund structures may use AHCs. Examples focussed on alternative funds where the manager (but not the fund vehicle itself) will be subject to regulation, but some mentioned that regulated fund vehicles might also sometimes find it convenient to hold assets in separate vehicles.

2.3 Examples also generally showed structures where the fund vehicle was transparent for tax purposes. In a transparent entity, such as a Limited Partnership (LP), members are treated as entitled to a share of the underlying income of the entity as it arises and are generally charged to tax on their share of the profits on that basis. By contrast, in the case of an opaque entity, a member is generally only taxed on amounts distributed to them by the entity.

2.4 Respondents said that a structure could include a large number of AHCs. The fund vehicle might hold one or more 'master' AHCs, each of which might own a number of further, subsidiary AHCs. The master AHC serves as a platform to administer a group of investments, for example in a particular class or subclass of assets. Subsidiary holding companies might then then hold individual assets (such as an individual property in a real estate fund or one of the companies or corporate groups invested in by a private equity fund) or tranches of assets (such as debt issued in a particular currency in a credit fund).

2.5 In practice, several further intermediate AHCs may sit between the master AHC and the AHCs that directly own investment assets. These intermediate AHCs will often be used to borrow money, as set out at paragraph 2.11 below.

2.6 Broadly, responses stated that funds use AHCs to hold investment assets because of the commercial and administrative benefits they provide as distinct legal entities that have limited liability, are opaque for tax purposes and allow funds to segregate investment assets and/or capital from different investors into different corporate vehicles.

2.7 However, the particular benefits and role of an AHC will depend on factors such as its place in the structure, the investment strategy and underlying assets, and the needs of investors.

Commercial

2.8 Respondents explained that one benefit of an AHC is its ability to contract with third parties to buy and sell assets on behalf of the fund. They said that an alternative fund structure will often use a limited partnership as the fund itself, and that this may not be a suitable legal form for direct acquisition of investment assets.

2.9 Similarly, respondents said that a corporate vehicle may find it easier to borrow money, to increase the amount of capital invested in fund assets, than a limited partnership.

2.10 Respondents also said that funds will segregate assets amongst different AHCs so that, for example, real estate and infrastructure investments are not held in the same company. AHCs can then borrow money from third parties with liabilities ring-fenced against the assets they hold. This can also facilitate co-investment by investors outside the main fund in a particular subset of the investment assets.

2.11 Respondents said that a chain of AHCs may be used where a fund borrows money from more than one lender. Each AHC will own the next AHC in the chain, until it reaches the AHC that owns the investment asset or assets. The lender with senior rights to repayment will lend to the AHC closest to the assets. Lenders whose rights are subordinated will lend to AHCs further away from the assets in the chain, in a way that replicates their rights to repayment.

2.12 Respondents explained that AHCs may also be used where multiple funds, or a fund and other investment partners, wish to invest in the same portfolio.

2.13 Some respondents said that AHCs may be used to segregate capital from different investors, for example where some investors wish to use borrowing to leverage their investment and others do not.

2.14 Respondents also suggested that AHCs allow funds greater choice as to how they sell investment assets, in that they can sell a group of assets together within an AHC, by disposing of the AHC, as well as selling each asset individually.

Administrative

2.15 Respondents said that AHCs may pay tax and handle filing obligations, for example in real estate funds where local taxes may be due on property income and gains. This prevents these obligations from falling on each individual investor, as would be the case if a transparent fund vehicle received the relevant income and gains directly.

2.16 Similarly, an AHC will reduce the administration required in accessing double tax treaty benefits in the jurisdictions where assets are located, by ensuring that a single claim can be made per holding vehicle, rather than per individual investor.

2.17 Respondents also explained that AHCs facilitate reinvestment of proceeds received on disposal of investment assets. If a transparent fund vehicle, such as a limited partnership, receives the proceeds, investors may be chargeable to tax on any gains, regardless of whether the money is reinvested or returned to them. The AHC can reinvest proceeds without a tax charge arising for investors on any sums it does not return to them.

2.18 Respondents also said that some management and administrative activity relating to fund assets may take place at the level of the AHC. For example, AHCs may handle hedging transactions to hedge against potential losses from foreign exchange movements. Depending on the structure, agreements defining the parameters for investment may sit at AHC level and the board of directors of the AHC may make decisions in accordance with those parameters.

AHCs in other funds and pooled investment structures

2.19 In addition to credit, real estate and private equity funds, discussed in the March 2020 consultation document, respondents noted the use of AHCs in infrastructure funds, venture capital funds and hedge funds that trade in underlying assets.

2.20 Respondents also said that AHCs may be used by institutions such as pension funds to hold their investment assets, and by wealthy individuals for private wealth management.

2.21 A number of responses discussed situations where an AHC might be used to structure arrangements where, for example, an investment fund and an institutional investor pooled funds for investment, or where several funds invest together in a group of assets via an AHC. Similarly, respondents said that AHCs could be used to allow particular investors to invest in parts, rather than the whole of an investment fund's portfolio.

2.22 The majority of respondents said that any reforms should apply broadly enough to benefit AHCs used in most of, if not all, of the investment structures and strategies outlined above.

Benefits to the UK of greater AHC domicile

2.23 Respondents argued that changes to UK tax rules to make this a more competitive location for AHCs would support and bolster the UK's position as Europe's centre for asset management services.

2.24 A number of respondents said that the Base Erosion and Profit Shifting project (BEPS) workstreams, particularly Action 6 on treaty abuse, have caused investors to review their structures and seek to locate fund management activity and AHCs in the same place. They said that this could help to ensure that arrangements involving the AHC had a non-tax principal purpose, which might be necessary to secure treaty benefits.

2.25 Respondents explained that, as a result, asset management activity currently based in the UK might re-locate overseas, to jurisdictions where AHCs are currently based. By the same logic, they said that facilitating the establishment of AHCs in the UK would help to retain asset management activity.

2.26 Additionally, respondents said that UK AHCs would require support services, for example in the tax, legal, administrative support, accounting and regulatory sectors. They said that this would create jobs and generate increased employment taxes.

2.27 Some respondents suggested that these jobs would not need to be based in London and could generate employment in other regions of the UK.

2.28 One response cited research estimating that, amongst the subset of alternative funds investing in infrastructure, there are currently around 7,191 AHCs located in 'intermediary' territories (that is, popular AHC jurisdictions which may not necessarily be the location of the fund or the underlying assets). The estimates showed these AHCs generating around 3,000 full time equivalent jobs and £3.2 billion service fees, growing to a projected 7,000 and £6.5 billion by 2030.

2.29 Several respondents referred to research into authorised funds from 2007, 'The Value to the UK Economy of UK-domiciled Authorised Investment Funds'. This concluded that every £1 billion capital invested in authorised investment funds domiciled in the UK generates nearly £1 million tax receipts in relation to costs linked to the domicile of the fund. Although this related to authorised fund vehicles rather than AHCs generally used by alternative funds, respondents suggested that this research was indicative of the benefits associated with UK location of vehicles in a fund structure.

2.30 With regard to investment in UK real estate, one response said that around 4,000 overseas jobs are linked to overseas collective investment vehicles.

2.31 Finally, respondents said the small taxable margin that, for example, credit fund AHCs might earn on interest income, could generate a modest boost in corporation tax receipts.

The impact of international tax changes

2.32 Respondents noted that measures such as the OECD BEPS Action 6 proposals, the OECD substantial activities requirement for no or only nominal tax jurisdictions and the Anti-Tax Avoidance Directive (ATAD) have caused many investment funds to reconsider their structures in situations where treaty benefits are relevant.

2.33 In particular, respondents referred to Action 6 as a reason for asset management activity to be located in the same jurisdiction as AHCs used by the fund, as discussed at paragraph 2.24.

2.34 Many respondents said that, given the scale of asset management activity currently in the UK, this would be a sensible location for AHCs if tax-related barriers could be removed. They also noted, for example, the already competitive environment in the UK for financial services and the costs that might arise on moving asset management activity overseas.

2.35 Numerous respondents suggested that changes in the tax system to accommodate AHCs could, if sufficiently comprehensive in addressing the barriers they identified, result in the establishment of significant numbers of AHCs in the UK.

Challenges to locating AHCs in the UK and proposed solutions

Question 4: For each of the fund classes identified in Chapter 3, what are the different challenges that the UK tax rules create for the establishment of AHCs in the UK? Are there any other fund classes for which similar challenges arise?

Question 5: How are the challenges to locating an AHC in the UK, to the extent they exist, currently overcome? How do the tax rules in other countries address these challenges?

Question 7: To what extent are there non-tax barriers to AHCs being located in the UK? If so, how might these dilute the impact of reform to existing tax rules intended to improve the UK's attractiveness as an AHC location?

Question 8: How could the challenges identified under Question 4 best be overcome?

2.36 Respondents explained that a range of factors will determine where funds choose to establish AHCs. They suggested that the UK's global importance as a financial services hub, its good infrastructure and skilled workforce make it a potentially attractive location for these companies. They also largely agreed with the March 2020 consultation document's representation of barriers in the tax system that mean AHCs are generally located overseas, even where substantial management activity occurs in the UK.

2.37 A number of responses framed their discussion of these barriers with reference to a "cardinal principle", "essential component" or "key objective" of fund structures, which was to leave the investor in no worse position, from the perspective of tax paid on investment income and gains, than if they had invested directly in the underlying assets. They explained that funds would therefore seek to avoid a situation where significant amounts of tax would be paid on these amounts by vehicles (including AHCs) within the fund structure.

2.38 When they discussed the tax an AHC might pay on its income, they emphasised that the AHC played an intermediate role enabling investors to make their investments, and that its taxable profit should be commensurate with this. With regard to the investors themselves, respondents said that, where these were individuals liable to UK tax, the fund would seek to ensure that any gains on disposal of investment assets by an AHC could be returned to investors in a form that would be treated as capital.

2.39 Respondents agreed that funds currently located AHCs in jurisdictions where they could already achieve these aims.

2.40 Respondents also suggested that, to have the greatest effect, reforms to address these barriers should be accompanied by wider tax and regulatory changes to make the UK a more competitive location for all parts of an investment fund structure. Many indicated that they would be contributing to the government's wider review of the UK funds regime, and that they viewed the March 2020 consultation on AHCs as an important first step of that wider project.

2.41 Further details of respondents' comments on barriers to establishment of AHCs in the UK are set out below.

Taxable Profit

2.42 Most respondents said that an AHC should not be exempt from tax. However, they emphasised the importance of ensuring that the tax payable by an AHC is predictable and commensurate with its role. Respondents suggested that funds would not locate AHCs in jurisdictions where there was significant uncertainty as to the amount of tax the AHC might have to pay, as this introduce an additional source of volatility for investors. They also said that a high taxable profit would not be commensurate with the role of an AHC and would place investors in a worse position than if they had invested directly in investment assets.

2.43 Respondents agreed that AHCs will generally manage their taxable margin on interest income using shareholder debt between the AHC and the investors. They said that this would be set up so that interest income received by the AHC is matched, save for a small margin, by interest payments to return that income to investors.

2.44 Many respondents said that AHCs are generally located in jurisdictions where they can make deductions for tax purposes for interest on 'results dependent' shareholder debt, used to pay returns on investments to investors. In the UK, these interest payments are generally treated as a distribution of profit rather than an expense, and deductions are therefore disallowed.

2.45 AHCs in private equity and real estate funds, as well as credit funds, might receive interest income where they advance loans to portfolio companies or sub-holding companies used for specific real estate assets. However, deductions for results dependent shareholder debt received particular emphasis in relation to credit funds. For example, a number of respondents explained that a credit fund AHC might acquire 'distressed' debt at a discount and ultimately realise a profit on disposal or redemption. 'Distressed' debt is, broadly, debt acquired on the secondary market for significantly less than face value due to doubts as to the debtor's ability to pay.

2.46 Respondents explained that interest payments on results dependent debt could increase to match profits, so that the margin remaining in the AHC after deductions would remain stable even though its income varied. They said that under current corporation tax rules, an AHC established in the UK might theoretically use debt with a fixed rate of interest to return income to investors whilst obtaining deductions on those payments when calculating their taxable profit. However, they said that this would leave the AHC subject to tax on significant amounts of profit in accounting periods when investments performed well, and that this would be disproportionate to its role as an intermediary.

2.47 Some respondents also said that results dependent shareholder debt was an administratively convenient way to return income to investors in a range of situations. They gave examples such as a credit fund AHC holding a large, diverse portfolio of debt or a real estate AHC receiving interest from a large number of sub-holding companies, where there would be potential changes in the make-up of the AHC's interest income with every change in the investment portfolio.

2.48 Many respondents recommended that the government enable deductions for results dependent shareholder debt for AHCs. Some also suggested the government allow deductions for a wider range of amounts currently classed as distributions, to give AHCs flexibility in the way they return income to investors.

2.49 Numerous respondents also discussed transfer pricing for shareholder debt. Transfer pricing rules can adjust the deductions available for transactions of this kind that take place between connected parties. The adjustment is determined with reference to the profit that would have arisen if the transactions had been carried out under comparable conditions by independent parties. Respondents expressed uncertainty as to how the UK would approach this for AHCs and a consequent uncertainty as to what tax an AHC would have to pay, which they said would prevent AHCs from locating in the UK.

2.50 A few explained that funds prefer to locate AHCs in jurisdictions where they are familiar and comfortable with the approach taken to determine an appropriate margin in line with transfer pricing rules. Some also pointed to investment vehicles in overseas jurisdictions for which transfer pricing requirements do not apply, or do not apply to shareholder debt.

2.51 Many responses advised the government to issue specific guidance to set out how AHCs should approach transfer pricing. Some suggested, for example, that guidance could set out what methodologies would be appropriate for an AHC or could confirm what profit margin would be acceptable. A few suggested that the government should introduce legislation, for example to specify the appropriate taxable profit margin for a credit fund AHC.

2.52 Respondents also discussed treatment of rental income from overseas property.

2.53 Some respondents suggested that where an AHC receives rental income from overseas real estate, this income should be exempt from tax on the basis that in many cases, it will already have been subject to tax in the jurisdiction where the real estate is situated. Respondents went on to note that relief is available in the UK for foreign tax paid in these cases, but said that this relief may not fully eliminate UK tax and that calculating the relief creates an additional administrative burden.

2.54 Some respondents requested that the UK's foreign permanent establishment exemption (the 'branch exemption') should be extended to cover all of a UK company's profits from an overseas property business. An overseas permanent establishment is where a company has a presence, via either a specific location or person, in an overseas jurisdiction through which it carries out its trade.

2.55 Finally, some respondents commented that the distribution exemption, which ensures that the great majority of dividends and other distributions received by UK companies will be exempt from tax, is important for AHCs. A few suggested that the associated analysis can be complex and requested a simplified exemption for AHCs.

Capital gains realised by an AHC

2.56 Respondents said that funds would seek to locate AHCs in jurisdictions where they could be confident that the AHC would pay no tax on gains. Alternatively, in the case of real estate, they said they would locate AHCs in jurisdictions where the AHC would pay no additional tax on gains, beyond taxes due in the jurisdiction where the property was located. They noted that gains realised by an AHC would be taxable or exempt, as appropriate, when returned to investors.

2.57 Respondents agreed that AHCs should be taxable on any gains on disposals of UK property and UK property-rich companies, which derive 75% or more of their value from UK land, reflecting UK tax policy in this area.

2.58 Respondents discussed two circumstances where an AHC might realise capital gains. The first related to real estate funds, in which an AHC might hold overseas property directly. Gains made on disposal of such property by a UK company would generally be subject to tax. Respondents suggested that such gains should be exempt from tax for the same reasons as rental income from overseas property, discussed under 'Taxable profit'.

2.59 The second and more general circumstance was on disposal of shares in another company, which might be a sub-holding company used to hold investments or, in the case of private equity, might itself be one of the underlying investments of the fund. Comments in this area focussed on the substantial shareholding exemption.

The substantial shareholding exemption (SSE)

2.60 The SSE provides an exemption from corporation tax for capital gains and losses realised where a UK company ('Company A') disposes of shares in another company ('Company B'). Amongst other conditions, company A must have held have at least 10% of Company B's ordinary share capital for a minimum period of twelve months (the 'substantial shareholding requirement'). In addition, Company B must have been a trading company or, if part of a group, a holding company of a trading group or sub-group (the 'investee requirement').

2.61 Where the investee requirement is not met, an exemption may still be available where 80% or more of the owners of company A are qualifying institutional investors (QIIs), or a proportional exemption where QIIs hold between25% and 80% of the shareholding. QIIs are investors who are exempt or immune from tax on gains and losses on investments which they make directly, and include pension funds, sovereign wealth funds and authorised investment funds.

2.62 One respondent expressed concern at the prospect of any expansion of the SSE, which they considered has a specific, targeted purpose and should not provide a general route to tax-free disposals of assets. However, most suggested a variety of changes.

Investee requirement

2.63 Many respondents commented that real estate funds will often dispose of properties within the 'wrapper' of a holding company. The holding company will not meet the investee requirement since it will not carry on a trade, meaning that an AHC in a real estate fund will only be able to access the SSE to the extent that the investors are QIIs.

2.64 A number of respondents commented that in a private equity fund, disposals of the companies or groups that make up the fund's investments should generally meet the investee requirement. However, they also said that determining whether Company B or the sub-group is trading will always involve some analysis, and can be complex. They also said that this question cannot be decided in advance, meaning that, at the point when the fund invests in a company, it cannot be certain as to whether gains on a future disposal of shares will be exempt from tax or not.

QIIs

2.65 Some respondents commented that the exemption for QIIs, introduced in 2017, was beneficial to funds. However, they noted that this exemption depended on the status of investors and was therefore unavailable or limited for many funds.

2.66 In addition, in cases where the exemption may apply, some respondents said that determining what proportion of investors are QIIs can be burdensome for funds with numerous investors. In circumstances where, for example, a fund invests in another fund, respondents said that tracing through the structure to consider all ultimate investors can be burdensome and that they may not have access to relevant information. They also noted that investors may include foreign institutions unfamiliar with the definition of a QII and whether it should apply to them.

2.67 A few respondents also suggested that the list of QIIs should be extended, for example to include REITs and to amend the definition used for life assurance businesses. However, most respondents suggested other approaches to make the SSE available to AHCs in a wider range of circumstances.

Substantial shareholding requirement

2.68 The substantial shareholding requirement is determined by ownership of the ordinary share capital of company B. A number of respondents commented that investment funds may hold investments in entities or undertakings such as partnerships, unit trusts, or specialist overseas vehicles that do not have ordinary share capital. Some respondents said that it is not always clear whether some holdings meet the definition of ordinary share capital or not, and a few requested further guidance on this subject.

2.69 Some respondents also commented that the twelve-month holding requirement could create difficulties, for example in situations where an AHC might purchase an investment to hold long term but make an early sale of a proportion of the investment within the first twelve months. Additionally, some noted that the 10% minimum holding requirement would exclude smaller stakes in companies, which certain credit fund AHCs might be likely to hold, for example if loans advanced to companies converted to equity.

2.70 Many respondents asked that the government replace the SSE with a broader exemption similar to the participation exemptions that are available in some overseas jurisdictions.

2.71 Most respondents suggested removing the investee requirement, either in its entirety or specifically for AHCs used by investment funds that met qualifying conditions. Respondents agreed that any such changes would need to be accompanied by rules to ring-fence sales of UK property-rich companies, to keep them outside the scope of the SSE.

2.72 For the substantial shareholding requirement, respondents recommended broadening the range of instruments and holdings that can be considered so that this was not limited to ordinary share capital. Some also suggested reducing the minimum holding to require the lower of 5% or a fixed minimum acquisition price, and amending the minimum holding period to include cases where part of company B was sold early, so long as a minimum holding was retained for twelve months.

Withholding tax on corporate interest

2.73 The UK tax rules require the deduction of withholding tax (WHT) at a rate of 20% on certain payments of interest. The main circumstances where tax will be payable are where a company makes a payment of interest to an individual or other non-corporate person, or where interest is paid by a person (individual, trustee or corporate) to another person whose usual place of abode is outside the UK.

2.74 Respondents explained that investors' capital will often be provided to AHCs using a mixture of equity (that is, shares in the AHC) and debt. The AHC will use payments of interest on the debt to return money to investors. Respondents explained that payments might be deductible in calculating an AHC's taxable profit. They also said that, even where this was not the case, AHCs would frequently wish to use interest as a more flexible method to make returns to investors than distributions, which would not be affected by the level of the company's distributable reserves.

2.75 In addition, many AHCs will borrow money from third party lenders, who may be overseas, in order to 'leverage' investors' investments and increase the total amount of money invested on their behalf. In both cases, interest payments may be potentially subject to WHT.

2.76 Respondents commented that UK tax rules provide broad and widely used exemptions from WHT on interest in the UK, but that obtaining these creates burdens not present in jurisdictions where AHCs are frequently located at present. They also suggested that the existence of these exemptions, along with other measures such as the corporate interest restriction (CIR), which limit the tax relief companies can obtain for payments of interest, would mean interest WHT could be removed without the UK losing significant amounts of tax.

2.77 The Quoted Eurobond Exemption (QEE) provides an exemption from WHT for interest-bearing debt issued by a company and listed on a recognised stock exchange (a list of UK and international exchanges approved by HMRC). A number of respondents estimated that listing generally costs between £20,000 and £30,000 per instrument. Respondents said that this cost and the administrative requirements involved in listing debt compared unfavourably with jurisdictions where no WHT is charged on interest or where an exemption is automatically available in many circumstances.

2.78 A few respondents said that where debt was listed to access the QEE, it was most convenient to use a foreign stock exchange such as the International Stock Exchange. They said this was unappealing for funds that would like their structures to be entirely onshore.

2.79 For interest paid overseas to recipients in a large number of jurisdictions, relief from WHT is available under double tax treaties. However, obtaining relief could involve making claims for every investor, and respondents explained that funds use AHCs in part to remove this kind of administrative burden.

2.80 Some respondents noted that for debts to third parties, AHCs may benefit from the exemption from WHT for qualifying private placements. However, they said that conditions for this exemption, such as the requirement that the debt have a minimum value of £10 million, mean it will not always be available.

2.81 More generally, respondents noted that the time taken to obtain an exemption could create difficulties where AHCs needed to issue new debt at speed.

2.82 Many respondents recommended that the UK remove the duty to deduct WHT on payments of interest in most or all cases. Some suggested that the UK adopt a broad, automatically applicable exemption with conditions to protect against abuse, such as:

- A requirement that lender and borrower not be related parties, or

- A requirement that the lender be resident in a jurisdiction with which the UK has a double tax treaty with a non-discrimination provision.

2.83 Alternatively, respondents suggested that the UK introduce a specific exemption for companies used as AHCs in investment fund structures, either applying to debt between an AHC and its owners or applying to all debt issued by an AHC.

Capital gains returned to investors

2.84 Respondents explained that in overseas jurisdictions where AHCs are frequently located, it is possible to return amounts to investors in a form that is treated as capital for tax purposes. For a UK individual, this will generally mean that the amount is subject to a lower rate of tax.

2.85 Respondents said that, where a UK AHC had disposed of a capital asset and realised a gain, it should similarly be able to return the gain to investors in a capital form, on the basis that the investor would have realised a capital gain if they had made the investment directly.

2.86 This was discussed most often with regard to private equity funds, which aim to realise large capital gains on the sale of the companies they invest in. However, some respondents also raised the issue with regard to credit and real estate funds.

2.87 Some respondents suggested that the ability to return amounts as capital to investors should include cases where, for example, a credit fund makes a profit on sale or redemption of 'distressed' debt. In a company, such profits are treated as credits under the loan relationship rules and thus as income. However, there are some circumstances where profit on the disposal of a debt by an individual will be treated as a capital gain.

2.88 Respondents noted that partial liquidations, which may be used to return amounts in capital form from AHCs in some overseas jurisdictions, are not permitted under UK company law.

2.89 Many respondents suggested that a UK AHC be able to return gains in capital form by repurchasing some of its shares from investors at a premium above the amount originally paid for the shares. In general, when a UK company repurchases shares, a premium of this kind will be treated as an income distribution in the hands of the recipients. Respondents suggested that this rule should be changed for AHCs so that the premium could be treated as capital, up to the amount of any gains realised by the AHC.

2.90 A small number of respondents suggested that, rather than repurchase its own shares, an AHC should simply be able to make capital distributions to investors. They said that this should be limited to circumstances where the distribution was funded by the disposal of a capital asset.

2.91 However, some responses also commented that an AHC's ability to repurchase its own shares or make a capital distribution could be limited by the amount of its distributable reserves. They said that the distributable reserves might be less than the money an AHC had available to distribute, for example where the AHC's profit had been reduced by depreciation expenses, which reflect the way assets depreciate in value over time but do not involve payments of cash.

2.92 A few respondents set out methods an AHC could use to repurchase its shares when its reserves were not sufficient, such as a reduction in share capital. One commented that this involves administrative difficulty and is not always possible, whilst another said that it is more cumbersome and costly than equivalent processes in some other jurisdictions.

2.93 Some respondents suggested that an AHC should be able to return amounts to investors in capital form through a repurchase of shareholder debt, with a premium up to the amount of any gains realised by the AHC, which they said would not be constrained by the level of the AHC's distributable reserves.

2.94 Most respondents' suggestions in this area specified that AHCs should only able to return amounts in capital form where this was funded by a capital sum received by the AHC.

2.95 Several respondents discussed the transactions in securities legislation (TIS). TIS is anti-avoidance legislation designed to counteract certain kinds of tax advantage. These respondents said that, if the government introduced new rules for AHCs to return some amounts in the form of capital, AHCs following these rules might need to seek clearances in many cases to be certain that TIS would not apply. To avoid the need for HMRC to provide clearances, respondents suggested that transactions in line with any such new rules be excluded from TIS.

UK property and real estate investment trusts (REITs)

2.96 Responses relating to investment in UK property focussed on the UK real estate investment trust (REIT) regime.

2.97 Respondents said that offshore property unit trusts (PUTs) are frequently used to hold UK real estate. They said that these vehicles can be structured so that they will be treated as transparent for tax purposes with regard to their income, with no tax charged, for example, on amounts treated as arising to exempt investors. Respondents also commented that offshore PUTs are easy to establish and provide the advantages of a company with regard to limited liability and borrowing from third parties.

2.98 Some respondents said that the UK could become a more competitive location for cases where funds currently use an offshore PUT by introducing an onshore vehicle with similar attributes. However, the majority of comments recommended changes to the UK REIT regime to make UK REITs a more attractive choice of holding vehicle for real estate.

2.99 Many responses on this subject suggested that the requirement for a REIT to be listed or traded on a recognised stock exchange leads to increased expense and administration and can delay setting up a REIT. Respondents also commented that, following changes to the rules in 2012, REIT shares can be held by a small number of qualifying investors (subject to the close company test). They said that it was not clear what function the listing requirement served in these cases. Recommendations included removing the listing requirement entirely or removing the requirement in cases where a proportion of investors are qualifying institutional investors.

2.100 A number of respondents suggested that the government consider expanding the 'institutional investor' list used for the purposes of the REIT rules. To qualify as a UK REIT a company must not be a close company, unless it is close solely because it has a participator which is a qualifying 'institutional investor'. Some respondents commented on entities not included on the list, including widely held funds as defined under the Non-resident Capital Gains Tax (NRCGT) rules, Authorised Contractual Schemes, US Endowment Funds, and government subsidiaries. Others suggested aligning the list of qualifying investors for REITs with the list of QII used for the purposes of the SSE.

2.101 Some respondents commented on rules regarding holders of excessive rights in a UK REIT. A holder of excessive rights, is, broadly, a company beneficially entitled to at least 10% of distributions paid out by a REIT or to at least 10% of the share capital of the REIT, or who controls 10% or more of voting rights in the REIT. A charge may be triggered in certain cases where a REIT makes a distribution to a holder of excessive rights.

2.102 Respondents said these rules could cause some investors to disaggregate their holdings across a number of vehicles and could discourage or prevent use of a UK REIT by certain investors who might wish to invest large sums in real estate via listed vehicles. Respondents agreed that holders of excessive rights rules should be retained where they prevent companies with larger stakes in a REIT accessing lower rates of taxation available under double taxation treaties, but suggested that the rules should not apply to qualifying exempt entities where there would be no risk of loss of tax.

2.103 Several respondents suggested that the balance of business test could be made more flexible, and that the current threshold creates a 'cliff edge' where a one-off commercial event could result in a breach. To meet the test, 75% of a REIT's assets and income streams must derive from property investment assets. If it fails this test, a company may not be able to access the tax benefits associated with the REIT regime. One specific suggestion was that the test be amended to look at the average position over three years.

2.104 Some respondents noted that rules relating to collective investment vehicles and NRCGT can 'look through' immediate investors to determine whether an entity is ultimately widely held. Some respondents proposed adding a similar look-though rule into the REIT regime so that a REIT can be used under a widely held or institutional fund vehicle.

2.105 Two respondents suggested that the government should consider amending the rules so that a REIT could be used to hold a single asset.

2.106 A few respondents suggested reforms to the REIT rules to make REITs better suited for multi-jurisdictional real estate investment structures. They recommended:

- An expansion of the foreign permanent establishment exemption, discussed a paragraph 2.54, so that distributions to investors relating to income and gains of an overseas property business would not be subject to deduction of tax at the basic rate

- Reforms to the SSE of the kind discussed at paragraphs 2.60-2.72, and
- Exclusion of overseas property holdings from the balance of business test

Stamp Duty and Stamp Duty Reserve Tax

2.107 Some respondents asked for certain exemptions on Stamp Duty Reserve Tax (SDRT) and Stamp Duty (SD) for transactions in relation to AHCs. They said this was an area that could impact the competitiveness of UK AHCs.

2.108 Respondents said that in overseas jurisdictions where AHCs are frequently located, transfers of shares in the AHC would not typically be subject to equivalent transaction taxes. It was also suggested that an exemption would generally align treatment of AHCs with the current treatment of units and or shares in UK authorised funds.

2.109 A few respondents specifically requested that when an AHC repurchases its own shares, the transaction should be exempt. One respondent noted that this would be particularly relevant if an AHC regime allowed amounts to be returned to investors in capital form via share repurchases.

2.110 Other respondents proposed exempting the transfer of AHC loan capital, including results dependent debt.

2.111 However, some respondents noted that the 0.5% charges to SD and SDRT would not necessarily create a significant disincentive to the establishment of UK AHCs.

Hybrid mismatches

2.112 The Hybrid and other Mismatches legislation seeks to tackle tax avoidance arrangements which take advantage of a difference in tax treatment of an entity or an instrument between two or more jurisdictions.

2.113 Numerous respondents discussed the application of these rules with regard to funds structured as partnerships. They held the view that it is wrong for all investors in a partnership to be deemed to be acting together by reason of having delegated the exercise of rights over an investee company to the fund manager. Some called for a removal of the rule treating partners as acting together. Some suggested an exclusion for investors in widely held collective investment schemes. Others favoured an approach akin to that adopted by Luxembourg, where there is a rebuttable presumption that any investor holding less than 10% of a fund is not acting together with their co-investors.

2.114 Some respondents expressed concern that the hybrid rules impose counteractions in cases where payments are made to hybrid entities whose investor bases include tax exempt entities. Their view was that it is not appropriate for the legislation to deny a deduction to the extent a payment traces through to such an exempt entity, given that the hybridity of the intermediate entity offers no potential tax saving to that exempt entity, which by its nature does not pay tax.

Taxation of Securitisation Companies Regulations (TSCR)

2.115 Some respondents suggested that the UK's existing Taxation of Securitisation Companies Regulations (TSCR) were designed with a structural objective similar to that for AHCs in credit funds. Several responses proposed that the TSCR could be adapted to provide a suitable taxation regime for AHCs of credit funds.

2.116 They suggested, for example, widening the activities securitisation companies can undertake, or removing the requirement that securities be issued wholly or mainly to independent persons.

2.117 By contrast, one respondent commented an overhaul of TSCR eligibility criteria to address barriers to credit fund AHCs would be detrimental to the stability of that regime. Another said that it would not be possible to provide the flexibility required by credit funds within the TSCR without unduly distorting the original intent of the regime.

2.118 A few respondents suggested that the government consider establishing a separate regime in which credit fund AHCs could be taxed on a retained profit, similarly to a securitisation company under the TSCR. They also asked for an exemption from VAT for management fees charged to such an AHC.

VAT

2.119 Several respondents indicated that the UK's approach to VAT can create incentives for AHCs to be domiciled outside the UK.

2.120 Firstly, responses recognised that AHCs will generally not be making supplies upon which VAT is charged. This means that any VAT incurred on input costs, which includes costs other than management fees (such as fees for professional services) and other basic infrastructure costs, will be irrecoverable. While the same issues arises for AHCs resident outside of the UK in some EU Member States, some respondents proposed reforms that would allow for AHC input VAT recovery.

2.121 A second area raised by respondents concerned fees for management services which might form an element of an AHCs costs. These fees will be subject to the VAT if the AHC is in the UK.

2.122 However, respondents recognised that these fees might not be subject to VAT if the AHC is located outside of the UK and the foreign jurisdiction treats the management service as an exempt supply - such as by treating the AHC as a Special Investment Fund (SIF). Respondents noted that as a UK AHC is unlikely to be considered a SIF, this creates a competitive imbalance and an incentive for AHCs to be located elsewhere.

Other tax issues

- Many respondents said that the competitiveness of the UK as a jurisdiction for AHCs is affected by the scope of the UK's double taxation treaty (DTT) network and the extent to which it provides relief from WHT imposed by overseas jurisdictions in which a fund's investment assets may be located. Some respondents commented that full relief may be unavailable from several major EU jurisdictions following the end of the

Transition Period when benefits under two EU Directives, the Parent-Subsidiary Directive and the Interest and Royalties Directive, are no longer available. They suggested that it would be important for the UK to obtain an outcome in relevant treaty negotiations, that replicates existing benefits.

- Some respondents raised a specific technical issue with regard to the UK tax rules on hedging foreign exchange risk on planned future acquisitions and disposals of shareholdings. To the extent that the existing 'matching' regime is not applicable, gains and losses on hedges may be taken into account as income items. Respondents suggested that it would be better for such gains or losses to be given capital treatment, as if they were an element of the acquisition cost or disposal proceeds of the shares in question.
- A few respondents suggested that the application of the loan relationship rules more generally could create 'dry' tax charges on profits recognised in a company's accounts when no money has been received, for example due to movements in the fair value of investment assets.
- Several respondents said that the UK's corporate interest restriction (CIR) was complex, could sometimes limit deductions for third party borrowing, and posed a barrier to the establishment of AHCs in the UK. However, others suggested that the CIR would not generally limit deductions for AHCs, many of which are likely to have net interest income.
- UK residents who have their permanent home ('domicile') outside the UK may not have to pay UK tax on foreign income. The rules determining which rules apply and what tax is due can be complex. Where an investment in overseas assets is made through a UK fund or UK resident company, income and gains resulting from those investments will have a UK source. Respondents noted that this would make it unattractive for non-domiciled individuals to make investments directly or indirectly through a UK resident AHC. Several respondents suggested that where a UK AHC holds overseas investment assets, income and gains arising from those assets should not be treated as arising in the UK for the purposes of non-domiciled individuals who use the remittance basis.
- A small number of respondents suggested that the technical analysis required to determine whether controlled foreign company (CFC) rules apply could deter establishment of UK AHCs. The CFC rules are anti-avoidance provisions designed to prevent UK companies artificially diverting profits to controlled companies overseas. There are five entity-level exemptions available to companies where they meet certain conditions, which provide that the profits of a CFC are exempt from the CFC charge.
- Two respondents suggested that there may be some uncertainty over the application of the employment related securities (ERS) rules for directors of AHCs where the directors are also members of the investment management firm, in particular where they are in receipt of performance related rewards ('carried interest'). It was suggested that HMRC produce clear guidance on its view of carried interest received by directors of AHCs.

- A number of respondents discussed perceptions that the UK tax rules are complex. They suggested that, for example, clear and readily available guidance on rules for any new AHC regime and the ability to obtain clearances on key transactions would help the UK's competitiveness as a location for AHCs.

Non-tax barriers to locating AHCs in the UK

2.123 Respondents suggested that funds would often seek to locate AHCs in the same jurisdiction as the fund vehicle. They said that avoided any need to consider two different legal, regulatory and tax regimes for these two parts of the investment structure, and meant that fund vehicle and AHC could easily share staff and service providers. In addition, they said that commercial benefits of this kind helped ensure that arrangements involving the AHC had a non-tax principal purpose, which may be a requirement for the AHC to access treaty benefits.

2.124 Respondents suggested that the wider variety of entity types and associated regulatory regimes could make other jurisdictions more suitable to many investment structures, and welcomed the review of the UK funds regime at Budget 2020.

2.125 A number of respondents suggested that the UK's departure from the European Union (EU), and the shape of the future relationship between the UK and EU, would affect the competitiveness of the UK to investment funds and fund structures, including AHCs. One response noted, for example, that it was important for fund structures to attract investment from all markets, including the EU. Many pointed to regulatory considerations regarding access to the Alternative Investment Fund Managers Directive marketing passport as a reason to locate asset managers within the EU.

2.126 Respondents raised several points relating to UK company law.

2.127 Many suggested that a UK company's ability to make distributions is more limited than in other jurisdictions. They suggested that this could create problems in certain circumstances where an AHC wished to return income or gains to investors, which it will generally aim to do as regularly and simply as possible. However, many also said that AHCs in various jurisdictions will often use interest payments on shareholder debt as a more flexible method to return money to investors in comparison to distributions, where they said that the AHC's ability to pay could be affected by the level of its distributable reserves.

2.128 A small number of respondents set out methods an AHC could use to repurchase its shares when its reserves were not sufficient, such as a reduction in share capital. One commented that this involves administrative difficulty and is not always possible, whilst another said that it is more cumbersome and costly than equivalent processes in some other jurisdictions.

2.129 When discussing the potential location of AHCs in the UK, some respondents said that UK company law does not permit migration of corporate domicile into or out of the UK. They said that if a fund wanted to move an existing AHC to the UK, they would therefore have to split its tax and corporate residency, so that it would be UK resident for tax purposes but would still be registered and domiciled overseas.

2.130 However, a number of respondents said that relocation of an existing AHC from one jurisdiction to anther could involve significant costs and administrative difficulty, and was generally unlikely. Respondents said that legislative changes to address the barriers they had identified could lead to funds establishing new AHCs in the UK, but was unlikely to stimulate migration of existing AHCs. Respondents said that it was common for alternative fund structures (including AHCs) to have a limited life of, for example, ten years, and that establishment of new AHCs in the UK was therefore a worthwhile aim.

Specific Rules for AHCs

Question 9: Do you consider that there is a case for the government to develop specific rules concerning the tax treatment of asset holding vehicles in alternative fund structures? What could those rules look like? How should eligibility be defined for qualifying fund structures and the AHCs within them?

2.131 Respondents took a variety of approaches to the question of specific rules for AHCs. Many suggested that the government create a bespoke regime available to qualifying AHCs that would take the UK tax rules as a starting point, with targeted amendments to address the barriers they had discussed. However, a range of other views were provided, and some respondents put forward more than one option. Proposals included:

- A mixture of AHC-specific interventions, for example to provide an exemption from the duty to deduct WHT on interest payments, and general changes to UK tax rules of a kind that would have effect for any UK company
- A standalone set of exemptions and reliefs for qualifying AHCs, that would address the barriers discussed through new rules that might copy from but would be entirely separate from existing legislation such as the SSE
- A specific regime for credit fund AHCs that would provide for tax on a margin determined in accordance with transfer pricing methodologies set out in legislation
- A blended approach that would take existing tax rules as a starting point but disapply, for example, much of the legislation covering loan relationships and derivative contracts

2.132 In addition, some respondents suggested that barriers to AHCs should be addressed entirely or largely through general changes, for example to remove the investee requirement from the SSE, or to discard the requirement to deduct interest WHT, with effect for any UK company. These respondents expressed concern that eligibility criteria for AHC-specific rules could create a cliff edge in tax treatment for structures that fell just outside the regime, give a competitive advantage to investors who could satisfy eligibility criteria and create additional administrative requirements in determining whether such criteria were met.

2.133 Several respondents said that they would support either general changes or specific rules for AHCs.

2.134 Respondents also suggested that, whether reforms took the form of AHC specific rules or not, they would need to address all of the major barriers identified for funds to establish AHCs in the UK in significant numbers. For example, some explained that if the UK provided for the various exemptions they had requested, but could not provide guidance or address significant points of uncertainty around transfer pricing for AHCs, this would be sufficient to deter many funds.

2.135 More generally, respondents discussed the need for certainty and stability in investment fund structures. They emphasised that once an AHC had been established in a particular location, it would be costly and administratively difficult to move. They said that, for this reason, funds would only establish AHCs in the UK if tax rules not only addressed the barriers identified, but could be depended upon to continue to provide for the same result over the life of the fund, which might be seven years or more. Several respondents said that AHC rules would therefore need to be carefully designed, so far as possible, to prevent the need for later changes which could create the impression of instability.

2.136 For similar reasons, a number of respondents requested that any specific rules for AHCs offer a clearance process for eligibility and/or key transactions by AHCs where the tax treatment might otherwise create uncertainty, to allow funds to confidently forecast tax liabilities.

2.137 Several respondents also commented that a regime for qualifying AHCs, with carefully designed eligibility criteria, would be unlikely to result in any loss of tax revenue for the Exchequer, as compared to general changes that might expand the reliefs available to any company.

2.138 Respondents also recognised that some barriers, for example with regard to capital returns for investors, could only be addressed through specific rules for qualifying AHCs and would not be appropriate to ordinary companies.

Eligibility Criteria

2.139 Respondents generally suggested that eligibility criteria for specific rules for AHCs should be as broadly drawn as possible, to reduce the potential for cliff edges or discrimination between different investment structures. They suggested, for example, that the regime should provide several alternative routes to entry rather than depend on a single test, and that criteria should avoid complexity wherever possible.

2.140 Some proposed criteria entirely oriented towards AHCs wholly owned by investment funds. However, responses to question 1, on the role of AHCs, often explained that one of the benefits of these vehicles was that they allowed for some investors to participate directly at AHC level, rather than via an investment fund. They discussed, for example:

- Arrangements where investment funds, institutional investors and/or other investors might invest together in a particular infrastructure or real estate project

- Participation by specific investors in specific fund investments or sub-sets of investments rather than the whole portfolio
- Co-investment by asset managers at AHC rather than fund level, in order to put their own capital at risk with regard to the investments they manage ('skin in the game')

2.141 Some respondents also discussed AHCs used entirely for the investments of institutional investors, for single or small groups of investors in arrangements to provide independent asset management of a more bespoke kind than available in larger funds, and for family wealth management.

2.142 A number of respondents therefore suggested broader eligibility criteria that could capture AHCs used for some or all of the above purposes. For example, one respondent proposed that rules for AHCs be open to, broadly, non-close companies in which an investment fund holds an interest of 25% or more. Some suggested that companies owned by exempt investors or qualifying institutional investors and used to hold investment assets should qualify as AHCs.

2.143 Some, but not all responses, also suggested that eligibility criteria should ensure that the AHC was used for the investment of capital pooled from a number of diverse, unrelated investors, or from one or more institutional investors.

2.144 Similarly, some responses suggested that the asset manager that managed the investments held by the AHC should be independent of the investors, except so far as the manager or their executives might themselves be required to hold a minority interest in the investments.

2.145 One respondent suggested that eligibility criteria should be oriented around the concept of independent management rather than the number or type of investors. They suggested that the investment management exemption, which enables non-residents to appoint UK based investment managers without the risk of UK taxation, could be used as a basis for these criteria.

2.146 With regard to the activity of the AHC, some respondents suggested anti-avoidance rules, for example requiring that avoidance of UK tax should not be a main purpose of the AHC. Others suggested that eligibility criteria should refer to investment in qualifying assets. A few suggested that an AHC should not carry on a trade. However, respondents who discussed this point often also proposed that a list such as that found at The Investment Transactions (Tax) Regulations 2014 be used to give certainty that specified activities would be treated as investment or not trading, or that HMRC provide reassurances on this point with regard to activities such as loan origination.

2.147 Respondents generally said that eligibility criteria should draw on familiar concepts so far as possible. Suggestions relating to ownership by a fund or investment entity tended to refer to some or all of:

- The definition of a 'collective investment scheme' in the Financial Services and Markets Act 2000

- The definition of an 'alternative investment fund' under the Alternative Investment Fund Management Regulations 2013
- The accounting definition of an 'investment entity' under IFRS 10

2.148 Respondents did not specify that AHCs should be limited to use by any particular type of fund vehicle. Those who commented on this subject suggested that regime rules could be agnostic on this point.

2.149 Respondents who suggested diverse ownership as a possible criterion tended to refer to some or all of:

- Genuine diversity of ownership (The Offshore Funds (Tax) Regulations 2009, regulation 75)
- Non-closeness, as defined for the purposes of rules on Non-resident capital gains for UK property rich collective investment vehicles (Taxation of Chargeable Gains Act 1992 Schedule 5AAA paragraph 46)
- Widely held funds (Statement of Practice 1 (2001) paragraph 37)

Chapter 3
Government's response

3.1 After careful consideration of the responses to the March 2020 consultation, the government believes that there is a clear case for reform in this area and proposes to introduce a new tax regime for AHCs.

3.2 The government recognises the complex range of circumstances and structures where AHCs are used and the variety of tax rules in question. We are therefore launching a second consultation, to seek views on the design features of an AHC regime. That consultation is found in the next chapter of this document, 'Consultation on delivery of a new tax regime for AHCs'.

3.3 The government has also decided to consult further on changes to the REIT regime proposed in the March 2020 consultation. These changes are discussed in the final chapter of this document, 'Consultation on changes to the REIT regime'.

3.4 The remainder of this chapter sets out the government's response to some specific points raised in the March 2020 consultation.

Options to address barriers through general changes to UK tax rules

3.5 Some respondents requested general changes to UK tax rules, for example with regard to WHT on interest and the SSE, in order to address barriers to the establishment of AHCs in the UK. These are discussed further below. The government does not view wider changes of this kind as the most suitable approach to accommodate AHCs.

3.6 A bespoke regime can limit the potential risks that would be associated with, for example, a more general loosening of conditions for certain reliefs. In addition, many respondents emphasised that significant numbers of AHCs would be unlikely to locate in the UK if some of the main barriers they discussed were left unaddressed. Not all of these barriers could be addressed through any form of generally applicable changes to existing tax rules.

3.7 For example, the government accepts that in the context of an AHC serving a specific role as part of an investment fund structure, it may be appropriate for investors to receive a capital return where this would have been the result if they invested directly in underlying assets. However, in general, the government views the business carried on by a company and the income and gains it earns in the course of that business as distinct from the transactions between the company and its shareholders. Shareholders are therefore taxed on distributions in accordance with the character of the transaction rather than as if they were indirectly carrying on the business of the company itself.

3.8 A bespoke regime will be able to deliver solutions in areas of this kind where the role and character of an AHC mean that a different tax treatment may be appropriate.

Withholding tax on interest

3.9 The UK has a number of domestic exemptions from WHT on interest. For example, the exemption for qualifying private placements was introduced in 2015 to support the development of a market in unlisted debt, and incorporates safeguards to ensure against abuse. The exemption for debt traded on a multilateral trading facility (MTF), which expands the Quoted Eurobond Exemption (QEE), was introduced in 2018 to enhance the competitiveness of UK wholesale primary debt markets. The MTF exemption maintains the link between regulatory requirements and the QEE, in that the MTF must itself be operated by a recognised stock exchange.

3.10 The government keeps the application of WHT and available exemptions under review. Whilst we are considering a potential exemption specific to qualifying AHCs, we do not propose to make any broader relaxation to the duty to deduct WHT from interest as a result of this consultation.

The substantial shareholding exemption (SSE)

3.11 Similarly, rather than amend the SSE, the government is proposing a specific relief for gains on disposals by a qualifying AHC.

3.12 The SSE was designed to address concerns that a corporation tax charge on share disposal gains could be unduly influencing business decisions on restructuring and reinvestment and creating incentives for groups to adopt complex offshore holding structures. The qualifying conditions and scope were reviewed in 2016. This led to significant simplification and reforms in 2017, which included the broader exemption now available to qualifying institutional investors and which have been well received by the general business community.

3.13 Respondents discussed a wide range of situations where an AHC might not obtain an exemption or full exemption under the SSE. Addressing these through general changes would involve a significant broadening of companies' ability to dispose of shares free of tax. The government does not view the specific position of an AHC as giving sufficient rationale for such a change.

Investment in UK real estate

3.14 Investors generally have to pay tax on rental income and gains on UK property even if they are resident overseas. Respondents recognised the UK's taxing rights in this area and their comments reflected general agreement that an AHC that paid tax only in relation to its role and left investors to be taxed on returns in their own jurisdictions would be inappropriate to this asset class.

3.15 The UK has specific tax regimes to facilitate investment in UK property, specifically real estate investment trusts (UK REITs), and property authorised investment funds (PAIFs). Exempt unauthorised unit trust (EUUTs) and coownership authorised contractual schemes (CoACS) are also well suited to holding UK property for certain investors.

3.16 UK REITs are exempt from UK tax on the income and gains of their property rental business, but distributions must be paid out of the property rental business profits and, together with any exempt gains that may be distributed, are payable under deduction of income tax at the basic rate. The rules required to achieve this can be complex in operation.

3.17 A small number of respondents suggested that a separate AHC regime should include rules to achieve a similar result. However, most responses relating specifically to investment in UK real estate focussed on the REIT regime. Respondents noted a number of areas where the REIT regime could be reformed, to remove unnecessary barriers and make it more competitive, including for use as an AHC.

3.18 Whilst a comprehensive review of the REIT rules is intended to form part of the wider funds review, stakeholders have suggested that there are a number of changes that could be made alongside the introduction of the AHC rules and that would have immediate benefits in making the UK a more competitive location for holding real estate assets. On this basis, the government is consulting further on those aspects of the REIT rules set out in chapter 5 of this document, 'Consultation on changes to the REIT regime', to the same timetable as the consultation on a new tax regime for AHCs.

3.19 Responses also set out that multi-jurisdictional real estate funds may hold properties through a local company or other entity which will pay taxes in the local jurisdiction. The government understands that an ordinary UK company may serve this purpose for UK property. The 'Consultation on delivery of a new regime for AHCs' at chapter 4 of this document includes discussion of these multi-jurisdictional structures and considers how or whether UK property could sit within a structure using AHCs without risk to the UK tax base.

Investment in overseas real estate

3.20 Some respondents requested that the UK's foreign permanent establishment exemption (the 'branch exemption') should be extended to cover any UK company's profits from an overseas property business. They noted that these profits will often be chargeable to tax in the jurisdiction where the property is located.

3.21 The branch exemption allows UK resident companies to exclude profits and losses attributable to an overseas permanent establishment from their corporation tax computation. This provides a degree of symmetry between the treatment of foreign subsidiaries of a UK company and foreign branches.

3.22 Providing an exemption for profits of an overseas property business conducted from the UK, by a UK company with no foreign permanent establishment, would go beyond the scope and intention of the branch exemption.

3.23 When income arises in a foreign country to a UK resident and that income is taxable in that foreign country, the UK may give its resident relief for the foreign tax by crediting the foreign tax against the UK tax charged on that income.

3.24 Given this, we are asking for more evidence to understand how important an exemption for overseas property income would be to make the UK a competitive location for AHCs used in multi-jurisdictional real estate funds.

Employment related securities (ERS)

3.25 Responses to the consultation questioned whether the ERS regime would apply to carried interest received in the form of a security for an individual who is a director of an AHC.

3.26 The application of the ERS regime in such a scenario is covered by well-established guidance (Section 1.2 of the MoU between the BVCA and H M Revenue and Customs on the income tax treatment of venture capital and private equity limited partnerships and carried interest, available in the Employment Related Securities Manual at ERSM30530). The application of the ERS rules is therefore dependant on whether the director of the AHC is in receipt of arm's length remuneration for the services they perform as a director.

3.27 As part of the consultation on delivery of a new regime for AHCs, we are asking for more information to understand respondents' concerns in this area.

The UK's Taxation of Securitisation Companies Regulations (TSCR)

3.28 Securitisation companies are used as part of certain transactions (securitisations) undertaken by businesses seeking to raise funds in the capital markets. They are used to issue debt to the market and to hold assets as security.

3.29 Securitisation structures are quite complex. The securitisation regime set out in the TSCR is designed around these structures and the specific role they perform, and aims to ensure that securitisation companies are subject to an appropriate tax charge.

3.30 The government believes that a new regime for AHCs is a better solution than attempting to broaden the specialist securitisation regime to provide the flexibility required by credit funds.

Hybrid mismatches

3.31 At Budget 2020, the government announced a consultation covering a number of aspects of the Hybrid and other Mismatches rules. The government published a response to the consultation on 12 November 2020. This responds to stakeholder feedback in a number of areas, including those raised in the March 2020 consultation on AHCs.

VAT

3.32 At Spring Budget 2020, the government announced a review of VAT on fund management fees, and some respondents expressed their support for this review, given that it could include within its scope fees charged to AHCs.

The government plans to publish further detail on this review and will provide an update in due course.

Other issues

3.33 UK-resident funds benefit from the UK's extensive double taxation treaty (DTT) network, which is a key selling point for locating funds in the UK. The UK keeps that network under constant review and has a rolling programme for the negotiation of new DTTs and for the renegotiation of existing treaties.

3.34 Some respondents discussed the UK tax rules on hedging foreign exchange risk on planned future acquisitions and disposals of shareholdings. The government believes that complex issues of this kind, which are relevant not only to asset holding companies but more generally, are better addressed separately rather than as part of a measure for AHCs.

3.35 We are seeking further evidence on the extent to which, for example, treatment of fair value movements on loans and derivatives, the controlled foreign companies (CFC) rules, the corporate interest restriction (CIR) and the conditions in the distribution exemptions may create barriers to the establishment of AHCs in the UK.

3.36 The government acknowledges that it may be unattractive for non-domiciled individuals to hold overseas investment assets through a UK AHC, and will consider how best to balance the importance of ensuring that the UK is a competitive location for AHCs against wider non-domicile policy objectives.

3.37 We will aim for any new rules on the tax treatment of AHCs to be as simple and easy to apply as possible. We welcome representations on any areas of potential difficulty, to ensure that guidance can address such points, and will consider whether there are any circumstances specific to AHCs where a clearance may be required. More generally, HMRC provide a wide range of guidance to help taxpayers comply with their obligations, and customers can apply for clearances or approvals from HMRC for a number of transactions.

3.38 Some respondents raised the impact of company law on the attractiveness of the UK as a location for AHCs. While this area is outside the remit of this consultation, we welcome the feedback received, which has been shared with the Department for Business, Energy and Industrial Strategy.

Chapter 4

Consultation on delivery of a new regime for AHCs

4.1 This section of the document is seeking views on how the government can best design a new regime for AHCs.

4.2 The government's objective is to deliver an effective, proportionate, and internationally competitive tax policy for AHCs that will remove barriers to establishment of these companies in the UK.

4.3 Respondents to the March 2020 consultation explained that funds will aim to ensure that their investors do not achieve a worse outcome than if they had invested directly in the underlying investments. AHCs are therefore generally located in jurisdictions where they will pay no more tax than is commensurate with their intermediate role in the fund structure, facilitating the flow of capital, income and gains between investors and underlying investments.

4.4 A new regime for AHCs should be suited to this role, whilst guarding against the potential for abuse or avoidance.

4.5 It should include the following key features:

- Robust eligibility criteria to limit access to the intended users
- An approach to taxation of the AHC itself that will ensure any tax it pays is commensurate with its role, and
- Rules for UK investors to ensure that they are taxed on income and gains received from an AHC broadly as if they had invested in underlying assets directly

4.6 The measure should not undermine the tax that the UK derives from investment activity or from UK investors in AHC-related funds. There may be a small impact on revenues from companies currently located in the UK which may qualify for the regime. However, we anticipate that the vast majority of qualifying AHCs will be newly established companies, which would otherwise have been located overseas.

4.7 In addition, the design of the regime should guard against any erosion of the UK tax base derived from UK property. It should not be possible, for example, for an AHC to be used to channel untaxed or minimally taxed UK property income and gains to offshore investors. The proposals below therefore suggest that AHCs should be prevented from using certain regime-specific deductions and reliefs in respect of UK property income and gains. They also consider preventing an AHC from carrying on a UK property business.

4.8 Finally, regime rules will need to be consistent with the UK's continued commitment to fully adhere to international tax standards, for example the OECD's BEPS minimum standards, including global standards on fair tax competition governed by the OECD's Forum on Harmful Tax Practices (FHTP). They will also need to be consistent with the UK's commitments to ensure its tax system does not discriminate between legally comparable operators.

Eligibility

4.9 The government believes that the rationale for bespoke rules for AHCs is clearest in structures where capital from diverse or institutional investors is pooled and managed by an independent, regulated or authorised asset manager, in which the AHC plays an intermediate, facilitative role.

4.10 These could be structures set up to enable numerous unconnected investors to benefit from the expertise of the manager and from the economy of scale that comes from pooling funds.

4.11 Alternatively, they could be structures set up to provide independent investment management for the capital of institutional investors who effectively act as an investment channel for others rather than on their own behalves, and are not actively involved in the conduct or operation of any portfolio companies held via the AHC.

4.12 In either case, safeguards against abuse are provided by features such as the need to serve the interests of a number of people, the resultant expectation of regular returns and/or appreciation of capital, and delegation of management to an entity subject to a layer of regulation. The government recognises that intermediate vehicles in these structures can appropriately benefit from tax rules that treat them as part of the investment infrastructure and avoid creating an undue wedge of tax between direct and indirect investment.

4.13 The government is therefore proposing eligibility criteria that will look for hallmarks of these arrangements. In practice, this will require rules to:

- Set criteria for the investors making investments via an AHC
- Specify how the investors should be identified
- Identify and set criteria for the asset manager, and
- Circumscribe the character and activities of an AHC

4.14 In addition to feedback on the approach to each criterion, the government is interested in views on whether the overall approach risks excluding certain investment structures there is a good rationale to include and if so, how those structures might be defined.

Criteria for investors

4.15 Criteria for the investors (in effect, the owners of an AHC) should protect against risks of manipulation of tax outcomes associated with funds or companies controlled by a small number of persons, such as members of a family or companies in common ownership.

4.16 They should seek to achieve this in a way that reflects overall principles for the regime and does not create unnecessary barriers. The government acknowledges concerns raised by some respondents around the potential for eligibility criteria for a bespoke regime to create artificial distinctions and distort commercial decisions around the way investments are structured.

4.17 Finally, the government agrees with respondents who said that, so far as possible, criteria should use familiar concepts, for example from regulation and tax law.

4.18 Two possible approaches are set out below. The first looks to require a fund vehicle above the AHC in the investment structure. The second looks directly at investors' interests in the AHC itself.

4.19 The first approach would involve looking for entities who invest their capital using a fund vehicle that is a Collective Investment Scheme (CIS) or an Alternative Investment Fund (AIF), as defined for the purposes of UK regulation. In other words, the regime could require that an AHC be wholly owned by a fund or number of funds that meet one of these definitions.

4.20 It could also potentially refer to REITs and their overseas equivalents. The government would be interested to understand whether and in what circumstances a vehicle of this type might wish to invest via an AHC within the regime proposed.

4.21 These definitions will not, of themselves, ensure that the fund is not controlled by a small number of investors other than institutional investors. The regime could also therefore require that the fund vehicle either:

- Meet the 'non-closeness' or the 'genuine diversity of ownership' test, to ensure that the fund is set up to benefit a diverse range of investors, or
- Be unable to meet either of those tests only because it has one or more qualifying investors

4.22 The regime could use the same definition of a qualifying investor as for NRCGT, which includes institutional investors such as pension funds, sovereign wealth funds, long-term insurance businesses and certain types of investment fund.

4.23 This approach would have the advantage that, as noted by several respondents, the CIS and AIF definitions encode some key features of collective investment.

4.24 However, it would also exclude a number of arrangements discussed in responses to the consultation.

4.25 The government would like to understand how common the following arrangements are and hear views on whether a UK AHC regime should accommodate them:

- Requirements for asset managers to invest directly in the AHC, rather than via a fund vehicle, in order to have 'skin in the game' and put some of their own money at stake on investments' performance

- More general pooling of capital directly at AHC level, for example between a fund and an institutional investor or an institutional investor and other partners
- Use of an AHC by a single institutional investor

4.26 If there is a good case to accommodate these arrangements, alternative eligibility criteria could look directly at the AHC to determine whether it was set up to benefit diverse or institutional investors, rather than requiring that the AHC be owned by a fund set up for that purpose.

4.27 This might mean that a company could only qualify as an AHC if it:

- Met the 'non-closeness' test, or
- Failed the test only because it had one or more owners who was a qualifying institutional investor, a fund vehicle that met one of the tests at paragraph 4.21, or a qualifying AHC

4.28 There could be significant complexity involved in attempting to apportion the effect of AHC rules, such as deductions for results dependent instruments, so that they were only available to some owners. If the regime accommodated owners other than funds, this might therefore mean that all owners could access its benefits, whether or not they invested via a separate fund vehicle.

Question 1: Do you think an AHC regime should include arrangements where some or all investors invest directly at the level of the AHC, as discussed at paragraph 4.25? Can you provide evidence on how common these arrangements are?

Question 2: Are there situations where legal agreements involving investors who invest directly at the level of the AHC are significantly different from those where all investors invest through a CIS or AIF? For example, would different investors' interests be fungible under these arrangements or could there be differences in the way some investors participate in the results of investments?

Question 3: Would a broader approach to eligibility, accommodating arrangements of the type discussed in Question 1, create increased risks of abuse or avoidance? If so, how could these be mitigated?

Identifying the investors

4.29 In applying criteria for investors, the regime will need to identify who those investors are.

4.30 The government anticipates that, broadly, a person making investments via an AHC will be a person who has an interest in and participates in the results of investment assets that the AHC acquires. Advancing a loan at a fixed rate of interest to an AHC on arm's length terms will not mean that a person is investing via the AHC, since they will simply receive a fixed, commercial return on the money they have advanced. However, a person who advances a loan to an AHC and receives a variable rate of return depending on the results of the investments will generally be making investments via the AHC.

4.31 Any test to identify the investors should be consistent with the commercial reality of investment arrangements. In practice, the legal documents used to determine the rights of participants in the underlying investments may often provide the best guide. The government would be interested in suggestions for any test that could refer directly to these documents.

4.32 Alternatively, investors could be identified using existing concepts from the UK tax code, such the concept of participation. This concept is used elsewhere, for example to determine whether a company is a 'close company' under the control of its directors or a small number of participators and safeguard against manipulation of such a company's affairs to return money to participators without an appropriate charge to tax.

4.33 The concept of participation has the advantage of considering the range of interests an entity may hold in a company, beyond ordinary share capital. It does not, however, consider the indirect interests an entity may hold in a company.

4.34 In many situations, this may be appropriate. The AHC regime should be available to companies serving a facilitative, intermediate role within an investment structure. It should not be available to companies at any level in a corporate group simply because the ultimate owner of that group is an investment fund.

4.35 However, given the wide range of structures that may be used for investment, there may be instances where investors' interests in a company genuinely serving the role of an AHC are held indirectly.

4.36 To accommodate situations of this kind, the government could explore adapting existing tests that take account of indirect ownership. For example, the concept of substantial indirect interest is used for the purposes of NRCGT, where collective investment vehicles can make an exemption election for entities in which they have at least a 40% interest. This might need amendment to limit the extent to which it was permissible to trace through a structure, to ensure that the regime was only open to companies serving an intermediate role.

Question 4: Is the concept of participation a suitable way to identify the investors in an AHC? Would this be consistent with the commercial reality of investment arrangements? Do you have any suggestions for an alternative approach, for example referring to the legal documents used to determine the rights of investors?

Question 5: How can regime rules accommodate structures where companies fulfilling the role of an AHC are not directly owned by the ultimate investors or by another AHC?

Management

4.37 The government proposes that an AHC should sit within an investment structure that uses an independent asset manager who provides investment management services, including managing fund assets, in return for an investment management fee.

4.38 Even if owned by an institutional investor, it is not clear that the rationale for AHC rules would apply to a holding company managed by its owners which served as an extension of their activity or vehicle through which they might take entrepreneurial decisions or conduct business.

4.39 To apply criteria for the asset manager, the AHC regime will need to identify that manager. This could involve looking to an undertaking that contracts to perform portfolio and/or risk management with regard to the assets held by the AHC. The government would like to hear views on whether this would be a suitable approach or whether alternative definitions may be more appropriate.

4.40 The government proposes that investment assets held by an AHC should be managed by an undertaking that is:

- Authorised or registered for the purpose of asset management, and
- Subject to supervision in their jurisdiction

4.41 In addition, the government proposes that the manager of investment assets held by an AHC should be independent of the investors.

4.42 To require that the manager be independent, the regime could use language from the regulatory definition of a collective investment scheme, by specifying that investors should not have day-to-day control over the management of the investment property. The regime could also use the 'independent capacity test' employed elsewhere in the tax code as part of the Investment Manager Exemption.

4.43 This requirement would need to include an exception for situations where asset managers or their executives have a 'carried interest' in investment assets as part of their performance reward and/or own a portion of fund assets so that they have 'skin in the game.' Regime rules would need to specify a maximum proportion of the AHC that could be owned by asset managers or their executives in accordance with commercial arrangements of this type. The government would like to receive evidence as to the situations these rules should permit.

Question 6: What is the best method to identify the asset manager who provides investment management services to investors in relation to the investments held by an AHC? Do you foresee complications, for example in a structure with multiple layers of AHCs? How can regime rules address these situations?

Question 7: What tests would best ensure that investment decisions are taken by an asset manager who is subject to regulation and has genuine independence from the investors?

Question 8: What would be an appropriate maximum proportion for asset managers' interests in an AHC, including interests held by individual fund executives? Can you provide details of relevant commercial arrangements?

Character and activities

4.44 The government believes that an AHC regime should only apply to entities that serve to facilitate flows of capital, income and gains between investors and investment assets.

4.45 A company should not, for example, be eligible for the regime if it is owned by a private equity fund with diverse ownership, holds independently managed investment assets but also carries on significant other activities that form part of the trade of a portfolio company invested in by the fund.

4.46 One option to achieve this would borrow from the regulatory definition of a collective investment scheme. AHC rules could, for example, require that an AHC's purpose be to enable the investors to participate in or receive profits or income arising from the acquisition, holding, management or disposal of investment assets.

4.47 Alternatively, the regime could use a condition such as that used in the definition of an investment trust at Corporation Tax Act 2010 section 1158, that all, or substantially all, of the business of the company be investing its funds in shares, land or other assets with the aim of giving members of the company the benefit of the results of the management of its funds.

4.48 The government is also considering whether it would be appropriate to specify that an AHC should not trade. We understand that companies fulfilling the role of an AHC will generally be carrying on investment business and not trading. However, we would like to receive evidence about any specific situations where, as part of an AHC's facilitative, intermediate role and for genuine commercial reasons, part of an AHC's activity might amount to a trade.

4.49 Some further requirements may be necessary to ensure that AHCs can only be used for their intended purpose. The government would like to hear views on whether an AHC regime should require any of the following:

- A minimum amount of capital raised for investment by an AHC
- Investment of capital in accordance with a defined investment policy, and
- A policy or practice of reinvesting or returning capital to participants when investment assets are sold

4.50 Additionally, the regime may need to include specific rules to safeguard against assets and/or related income being ring-fenced for the benefit of a subset of investors in a way that would be contrary to the aims of the ownership criteria set out above.

Question 9: How should regime rules ensure that the activities of an AHC are limited to a facilitative, intermediate role between investors and investments?

Question 10: Can you provide evidence about any specific situations where, as part of an AHC's facilitative, intermediate role and for genuine commercial reasons, part of its activity might amount to a trade?

Question 11: Should eligibility criteria include the requirements set out at paragraph 4.49?

Question 12: How could regime rules safeguard against assets and/or related income being ring-fenced for the benefit of a subset of investors?

Question 13: Could the proposed approach to eligibility include arrangements that you believe should not be included within an AHC regime?

Question 14: Could the proposed approach to eligibility exclude arrangements there is a good rationale to include within the regime? If so, how might relevant structures be defined? Are there structures designed to facilitate alternative finance arrangements that could be excluded?

Profit on income received by an AHC

4.51 The regime should ensure that any taxable profit recognised by a qualifying UK AHC is proportionate to its role, which the government understands will involve facilitating the flow of income and capital between investors and investment assets.

4.52 Depending on, for example, the activities of the AHC and the investments it holds, this could mean it will recognise a small taxable profit of the kind an independent entity might make if it fulfilled the same role for investors, in recognition of the value it provides. However, it should not result in a situation where use of an AHC creates a significantly worse tax outcome for investors than if they had invested in underlying assets directly.

4.53 Respondents raised three main concerns in this area. The first relates to the deductions an AHC can make against its taxable income. The government is considering whether to allow deductions for results-dependent instruments in order to address this point, or whether a broader approach, applying to a wider range of payments to investors, would be more appropriate.

4.54 The second relates to transfer pricing and how these rules should apply to an AHC.

4.55 The third issue, relating to tax on overseas property business income, is considered under 'Multi-jurisdictional real estate funds', below.

Deductions for payments to investors

4.56 A number of responses discussed situations where the taxable income received by an AHC might vary significantly, for example in a credit fund investing in 'distressed' debt. They suggested that under current corporation tax rules, this could leave the AHC subject to tax on varying and sometimes significant amounts of profit in accounting periods when investments performed well, and that this would be disproportionate to its role as an intermediary.

4.57 The government believes that any taxable profit recognised by an AHC should be proportionate to its role facilitating investment for diverse and/or institutional investors. We anticipate that the investors themselves will be exposed to the major risks and rewards associated with the performance of underlying investment assets, and will contract with an independent asset manager to manage those investments.

4.58 Provided the AHC follows a practice of returning such amounts to investors, it should be able to obtain relief against its taxable income without significant volatility. The total permissible relief should however be limited in accordance with transfer pricing principles. An AHC should not be able to obtain deductions for any payments to investors that would reduce its remaining profit below an amount proportionate to its role.

4.59 One means to approach this, in line with a number of respondents' suggestions, would involve allowing an AHC to obtain relief against its taxable income for interest payments made to investors on results dependent debt, where the deduction would usually be disallowed as a distribution. A rule of this kind could also encompass certain derivative contracts where deductions might usually be disallowed as disguised distributions or as involving the transfer of corporate profits. Total deductions would be limited in accordance with transfer pricing principles.

4.60 A simplified example of a results dependent instrument would involve an investment fund lending £20m of investors' capital to an AHC to acquire a portfolio of assets. Rather than pay a fixed amount of interest, the AHC might commit, in return, to pay the fund 95% of the income produced by the investment portfolio. The payments made by the AHC would therefore depend on the results of the investments.

4.61 An AHC regime could include rules enabling deductions specifically for this kind of instrument. However, the government believes there may be a case for a broader approach and that, so long as the overall allowable deduction is subject to an appropriate limit, it may be possible to achieve a suitable result without attempting to tie legislation strictly to a particular form of debt or derivative contract.

4.62 For example, some respondents suggested that, rather than create a specific rule for results dependent instruments, an AHC should be allowed to make deductions for any distributions other than dividends.

4.63 Alternatively, the regime could allow AHCs relief against taxable income for amounts returned to investors, regardless of the particular method. Instead of depending on the form of payment, this might treat the full amount returned as an expense of the AHC, with a limit on deductions determined according to transfer pricing principles.

4.64 Any such approach would need to have regard to the potential for abuse or unintended consequences. Regime rules would need to ensure, for example, that interest income received by an AHC could not be transformed into distribution income that would be exempt in the hands of any UK companies investing via the AHC. In addition, deductions in the case of, for example, dividends paid to shareholders could affect what rules the regime might require to ensure that AHCs recognise an appropriate level of taxable profit in line with their role.

4.65 It will also be necessary to consider the overall result an AHC may achieve for tax in cases where it is realising gains (which are expected to obtain an AHC-specific relief or exemption) as well as taxable income, and obtains deductions for payments on results dependent instruments and/or relief for other costs or payments to investors.

4.66 Under the normal corporation tax rules, the extent to which a company can set costs of borrowing and other expenses against taxable income, and potentially reduce tax on that income to nil, will not necessarily be affected by the extent to which those expenses may be seen as associated with, for example, a gain that is exempt under the SSE.

4.67 The government would like to explore whether such outcomes would be appropriate for AHCs and the extent to which the rules contemplated as part of the regime make those outcomes more likely to arise.

4.68 If such outcomes are inappropriate for an AHC, the government will need to consider how the regime can ensure that an AHC is subject to tax on a suitable measure of profit on taxable income.

Question 15: Can you provide evidence as to the methods and instruments an AHC might use to return income and capital sums to investors and the commercial, administrative and tax considerations that will inform this choice?

Question 16: What advantages or disadvantages could there be in allowing a broader range of deductions to calculate an AHC's profits? Do you consider that the better alternative would involve deductions for specific instruments? Or do you think the regime should take a broader approach based on the totality of amounts returned to investors?

Question 17: To what extent would the outcomes discussed in paragraphs 4.65-4.68 be appropriate for AHCs, and to what extent do the rules contemplated as part of the regime make these outcomes more likely? If such outcomes are inappropriate, how can regime rules ensure that an AHC is subject to tax on a suitable measure of profit on taxable income?

Transfer pricing

4.69 An AHC should not be able to obtain relief for any payments to investors that would reduce its profit below an amount commensurate with its role.

4.70 Depending on the deductions available to an AHC, it may be possible to achieve this simply by ensuring that transfer pricing rules apply to AHCs.

4.71 Alternatively, regime rules could, for example, refer specifically to the functions performed, assets owned and risks borne by an AHC or in order to determine its overall taxable profit.

4.72 The government welcomes views on this question, which we anticipate will connect with respondents' views on the range of deductions that should be allowable for an AHC.

4.73 With regard to the general application of transfer pricing principles, respondents to the March 2020 consultation expressed uncertainty regarding the UK's potential view and approach to AHCs.

4.74 The government understands that AHCs' affairs will generally be very simple. Where the AHC's role is limited to facilitating the flow of capital, income and gains between investors and underlying investments, the complexity of its transfer pricing should be similarly limited. For example, respondents have suggested that, depending on the facts and circumstances of the case, the arm's length return of a credit fund AHC for its lending and borrowing might be best evaluated by ensuring that profit meets a sufficient return on cost or a sufficient return on gross lending volume.

4.75 We would welcome information on how funds might approach transfer pricing for any instruments where deductions are not currently available in the UK, and on points of potential difficulty or complexity in this area. We will consider what guidance might be appropriate to address respondents' concerns.

Question 18: What is your view on the best method to ensure that an AHC cannot obtain relief for any payments to investors that would reduce its profit below an amount commensurate with its role?

Question 19: Can you provide information on how funds approach transfer pricing for any instruments where deductions are not currently available in the UK? Can you provide examples from existing companies fulfilling the role of an AHC to illustrate any areas of potential difficulty?

Capital gains realised by an AHC

4.76 The government believes that an AHC should not pay tax on capital gains on disposal of investment assets. We anticipate that gains will be reinvested or returned to investors. Investors who dispose of their interest in the AHC will be taxable according to their status on any gains, reflecting any growth in the value of the investment portfolio, including where this relates to gains reinvested. Where proceeds on disposal of investment assets are returned, the transaction will similarly result in a potential tax charge for the investor.

4.77 The government therefore proposes that AHCs be able to obtain relief for gains on disposals of investment assets.

4.78 This relief should apply instead of the substantial shareholding exemption (SSE), in order to prevent the potential complexity that could arise if an AHC had two alternative routes to relief on the same amount.

4.79 In order to preserve the tax base in UK property, the relief should not apply to disposals of UK land or any assets that derive 75% or more of their value from UK land (UK property rich assets).

4.80 The relief could be designed as an overall exemption for gains or could operate via several interlocking reliefs or exemptions, to ensure that amounts not yet returned to investors were easily identifiable.

4.81 For example, if gains are reinvested a number of times, it will be necessary to identify the cumulative gain so that, on any ultimate return to investors, where those investors are UK resident, the full amount can be treated as a gain in their hands.

4.82 In addition, if the AHC leaves the regime, it may be appropriate for any cumulative gains of this kind to become taxable on a future disposal.

4.83 Both aims could be achieved if the regime provided a roll-over relief for gains in respect of amounts reinvested in new investment assets. This could be modelled on the existing Business Asset Roll-over Relief. The amount of the gain reinvested would be deducted from the base cost of the new asset. The result would be to increase any subsequent gain (or reduce the amount of any loss) when the new asset was disposed of, according to the amount of the gain on the old asset.

4.84 The government anticipates that most gains not reinvested will be returned to investors and should obtain a relief or exemption on this basis. Where relief is already available in respect of the amount returned, regime rules may need to protect against double counting so that a double relief is not available in respect of a single amount.

4.85 Some amounts may be used instead to cover costs such as expenses of management. Where this is the case, the amount of the costs themselves will generally be available to provide relief against gains when calculating amounts chargeable to tax.

4.86 Additionally, there may be circumstances where, for example, an AHC is unable to return the full amount of a gain to investors due to constraints on its ability to make distributions. The government anticipates that amounts not returned for these reasons will be small and does not believe that an AHC should be subject to tax on such amounts, so long as its general practice is to reinvest or return any gains.

4.87 Regime rules should however ensure that gains not returned or reinvested are identifiable. Similarly to gains reinvested, it may be appropriate for these amounts to become taxable if the AHC leaves the regime.

4.88 The government is additionally concerned that an AHC regime should not be used to artificially defer tax on capital gains. It would not be appropriate, for example, for an AHC to continue to hold cash received on disposal of a capital asset until wanted for use by investors, merely to defer the point at which those investors would be chargeable to tax. The government welcomes views on the level of risk in this area and the most suitable response.

Question 20: Will the proposed treatment of capital gains realised by an AHC provide an effective means of ensuring that AHCs do not pay tax on gains they reinvest or return to investors?

Question 21: Could the relationship between the relief proposed for gains and other potential reliefs available to an AHC create undue complexity or unintended consequences?

Question 22: How could rules on relief for gains be protected from abuse in a way that is simple and easy to administer? Would a requirement of the kind discussed under 'Eligibility', that AHCs have a policy or practice of reinvesting or returning capital to participants when investment assets are sold, help achieve this aim?

Withholding tax on payments of interest to investors

4.89 The government is exploring whether or to what extent an AHC should be exempt from the duty to deduct a sum representing income tax on payments of interest to investors. This deduction of tax is often referred to as withholding tax (WHT).

4.90 Where imposed, this duty serves to collect UK tax on payments of interest from UK entities to overseas entities and UK individuals. Payments to UK companies are generally exempt.

4.91 The government anticipates that any UK individuals who might receive and be liable to tax on such income from an AHC will pay tax at the appropriate rate via their self-assessment tax return.

4.92 In the case of overseas entities, the government does not believe that the movement of their investment income through the UK via a UK AHC should necessarily lead to the imposition of UK tax on the investor, any more than flows of investment income should be subject to tax in the AHC.

4.93 In practice, as noted by respondents, funds can generally obtain relief or an exemption from UK WHT. However, this involves some administrative burden. In the context of an AHC, a bespoke exemption may therefore be more appropriate.

4.94 The government is exploring what risks may be associated with such an exemption, for example in relation to diversion of investment income to low tax territories. We would be interested in views on whether and what conditions could be employed to mitigate these risks.

4.95 For example, a WHT exemption for AHCs could include a purpose test that would disapply the exemption where there was a main purpose of escaping tax imposed by any jurisdiction. It could also or alternatively be available only where recipients are resident in qualifying territories.

4.96 However, conditions of this type should only be applied if they have real value in reducing risks that the regime would be misused and should not create unnecessary burdens or uncertainty for users of an AHC regime.

Question 23: To what extent could a WHT exemption for payments of interest by AHCs to investors create risks around the diversion of investment income to low tax territories?

Question 24: How could regime rules mitigate these risks? Do you think any WHT exemption for AHCs should include a purpose test and/or be limited to interest paid to recipients in qualifying territories?

Income and gains paid to investors

4.97 The government proposes that AHC rules should operate so that, for investors within the scope of UK tax:

- Amounts deducted from taxable income of an AHC and paid to investors are treated as taxable income in the hands of those investors, and
- Amounts returned to investors that are attributable to capital gains realised by an AHC are treated as gains in the hands of those investors

Income

4.98 Where an AHC has obtained relief against its taxable income in respect of payments to investors, the investors themselves should be treated as receiving taxable income to reflect the full amount of their proportionate share in the relief.

4.99 This should take priority over any rules to treat amounts as capital in the hands of investors.

4.100 Depending on the deductions permitted to an AHC, regime rules may need to specify what kind of income an investor has received. For example, if an AHC receives interest income and obtains relief against that income for a payment that might be classed as a distribution, regime rules could specify that the relevant amount should be treated as interest in the hands of a UK investor.

Question 25: How can regime rules ensure that amounts of income returned to investors are treated appropriately for the purposes of UK tax?

Gains

4.101 The government proposes that amounts returned to investors that are attributable to capital gains realised by an AHC should be treated as capital gains in the hands of investors.

4.102 Respondents noted several different transactions which an AHC might use to return gains to investors. It might repurchase its own shares from investors at a premium, repurchase debt from investors at a premium or make distributions.

4.103 In any of these cases, special rules would be needed as part of an AHC regime to classify an appropriate amount as a gain in the hands of a UK investor.

4.104 One possible method to achieve this would involve designating amounts returned to investors as pure capital gains where these were funded by gains in the AHC. No element of cost would be deducted, so the full amount of the gain returned to the investor would be taxable as a gain in their hands. The method could potentially apply to any payment from the AHC to investors, including dividends, premiums on repurchases of shares, premiums on repayments of debt and payments of interest.

4.105 The total amount that could be designated as a gain would be subject to a priority rule. This would ensure an appropriate amount would always be treated as taxable income in the hands of investors in respect of amounts deducted from taxable income of the AHC, before any amount could be treated as a gain. There would also be an overall limit to ensure that no greater amount could be designated as a gain than the investor's total proportionate share of net capital gains realised by the AHC.

4.106 The regime would need to ensure broad parity of treatment between investors, taking account of the different tax rules that apply to companies and individuals. Rules for corporate investors would need to protect against the risk that gains that would be taxable if they invested in underlying assets directly could be transformed, via an AHC, into exempt distributions.

4.107 Regime rules would also need to consider situations where the AHC returned gains to investors in a way that, from the investor's point of view, was simply a redemption of debt or repurchase of shares at face value. In accounting periods X to X+2, for example, an AHC might first use all consideration received on disposal of investment assets (including gains) to repay its debts to investors at face value, plus any interest that had accrued. The AHC might only begin to return amounts by any other route in accounting period X+3, once all of its debts were repaid. From that point, it might use distributions to return the full amount of consideration (not only the gain) received on further disposals.

4.108 In accounting periods X to X+2, gains realised by the AHC might therefore be significantly greater than any amounts received by investors other than repayments of their loan capital. From accounting period X+3 onwards, after all debts were repaid, the income received by investors might be significantly greater than any gains realised in the same period by the AHC or, indeed, than the AHC's total profit for that period.

4.109 One option for these situations would be to ensure that, at the point when the AHC obtained relief for returning a gain to investors, a corresponding amount would always be treated as a gain in the hands of UK investors. In practice, where the amount was returned via a repayment of capital, this would mean treating a gain as accruing to investors to the extent that the repayment was funded by a gain in the AHC. A simplified example might involve an AHC that sold an asset for £10 million, realising a gain of £2 million. If the AHC used the full £10 million to repay debts to investors, £2 million of that amount could be designated as a gain. Investors would need some compensating relief, to make up for the transformation of a repayment of capital into a taxable payment. Such relief could potentially be set against future payments from the AHC or a disposal of the investor's holdings in the AHC.

4.110 An alternative option, rather than treat gains as accruing on repayments of capital, might be for an AHC to carry forward a notional pool of amounts to be designated as gains (subject to priority rules) as and when the AHC made other payments to investors such as distributions. The government would need to consider what mechanism was best suited to achieve this and what risks might be associated with a potentially lengthy gap between the point at which an AHC realised a gain and the point at which amounts it returned to investors were designated as gains.

4.111 For any method to treat amounts as gains in the hands of investors, it would be important to accurately identify and value an investor's interest in the AHC in order to determine their proportionate share in its gains. The government would like to receive evidence on the best way to achieve this. We would like to understand what different instruments investors might hold, what rights might be attached and how these holdings might change over time.

4.112 In addition, the government recognises the need to consider how other parts of the tax code would interact with whatever method was used. For example, respondents were concerned that the transactions in securities rules could counteract the treatment of amounts as capital for individuals. We welcome further suggestions as to rules that might have unforeseen consequences in this context.

Question 26: What is your view on the most appropriate method to treat amounts as capital gains in the hands of investors?

Question 27: How should regime rules ensure that amounts designated as gains cannot displace amounts that should be treated as income in the hands of investors?

Question 28: How can an investor's interest in the AHC be appropriately valued in order to determine their proportionate share of any gains? What instruments might investors hold, with what rights attached, and how might these holdings change over time?

Question 29: Are there other areas of the tax code that could counteract the intended effect of rules to treat amounts as gains in the hands of investors or produce unintended consequences?

Gains: anti-avoidance

4.113 Any method of the type suggested above would need to include proper safeguards to protect against abuse. For example, an AHC should not provide a way around rules that counteract schemes to provide individuals with a lower tax liability by converting income to capital.

4.114 One approach would be to test whether a gain realised by the AHC would have been treated as a gain in the hands of the investor. This would prevent the AHC from returning amounts in a capital form to individuals in situations where, if there had been a direct disposal, anti-avoidance rules would have applied to treat the amount as income.

4.115 However, the government would also be interested in any suggestions that might make use of the particular context of an AHC to achieve the same aim via a single, streamlined test. For example, the government could consider identifying appropriate disposals by referring to assets that would reasonably be regarded as the underlying property in which investors had invested their capital.

Question 30: How could rules to treat amounts as gains in the hands of investors be protected from abuse? Is there a streamlined test the regime could use to safeguard against conversion of income to capital?

Gains: loan relationships

4.116 Some respondents suggested that certain types of profit on loan relationships, such as profit on disposal or redemption of 'distressed' debt, should be treated as capital for the purposes of an AHC regime, so that relevant amounts could be returned to investors in the form of capital gains.

4.117 In practice, market participants can structure financial instruments in many different ways. Economically there is very little that distinguishes one sort of cashflow under a financial instrument compared with another.

4.118 For this reason, the loan relationship rules tax or relieve all amounts from financial instruments as income.

4.119 The government is not convinced that there are any clear methods to distinguish certain amounts as capital in this context without creating undue complexity and potential for income-to-capital conversion. We would welcome further discussion as to whether any appropriate methods might be devised in this area.

Question 31: Should the regime allow certain types of profit on loan relationships of an AHC, such as profit on redemption or disposal of 'distressed' debt, to be treated as capital? Is there an appropriate method that could be used for this purpose?

Real Estate

Multi-jurisdiction real estate funds

4.120 The government would like to understand how suitable the AHC regime proposed would be to multi-jurisdictional real estate funds, which hold property in multiple countries. Gains realised by AHCs in these structures will obtain relief under general rules for capital gains realised by an AHC. However, where such AHCs receive rental income from an overseas property business, this presents some specific questions.

4.121 In many cases, as in the UK, an overseas jurisdiction will have taxing rights over local property. For this reason, whereas most funds are structured to minimise tax liabilities before income and gains reach the ultimate investor, the government understands that some real estate fund structures will use holding companies or other special purpose vehicles (SPVs) to handle local tax obligations. Beyond these obligations, the fund will aim to minimise further tax liabilities within the structure before income and gains reach the investors themselves.

4.122 This can result in a structure where a master holding company owns investment properties through a number of SPVs. The structure may also involve a number of intermediate holding companies that sit between the master holding company and SPVs and are used to borrow money from third party lenders.

4.123 The SPVs receive property income and, in some cases, gains, and are liable for any local taxes on these amounts. Properties may also be sold within the 'wrapper' of the relevant SPV, with proceeds (including any gains) received by the next company above the SPV in the structure. SPVs and intermediate companies return income and gains to the master holding company in the form of interest and dividends.

4.124 SPVs used in the structures described above will often be located in the same jurisdiction as the properties they are used to hold, but there are circumstances where an SPV will instead be located in the same jurisdiction as the master holding company.

4.125 The government would like to understand the situations where a UK AHC might be used in this way, to own and receive overseas property income directly. A number of respondents suggested that UK AHCs should be exempt from UK tax on overseas property income. We would like to understand how important an exemption of this kind would be to make the UK a competitive location for AHCs used in multi-jurisdictional real estate funds.

Question 32: Can you provide evidence on the number and type of situations where a fund might wish to use UK SPVs to own and receive overseas property income directly?

Question 33: Given the availability of relief in the UK for foreign tax paid, to what extent would the lack of an exemption for overseas property income act as a barrier to the use of UK AHCs to hold overseas property? Can you provide any examples of specific situations affected by this issue? To what extent would this affect the choice to locate master and intermediate holding companies in multi-jurisdictional real estate funds in the UK?

UK property

4.126 The AHC regime should not create any unprotected risks of loss of tax on UK property income and gains. It should not be possible, for example, for an AHC to be used to channel untaxed or minimally taxed UK property income and gains to offshore investors, insofar as they are not then subject to UK tax on those amounts.

4.127 One option to achieve this would be to specify that an AHC should not own any UK land or UK property rich assets.

4.128 The government would like to understand whether this would be an appropriate solution, or whether there are situations where investors would want to use an AHC or ordinary company owned by an AHC to invest in UK property, for example as part of a multi-jurisdictional fund of the kind described above.

4.129 If an AHC were allowed to invest in UK property, regime rules would need to ensure that the additional deductions and reliefs available to an AHC, such as relief for interest payments on results dependent instruments:

- Could not directly be used against income and gains on UK property, and
- Could not indirectly enable greater relief against such income and gains than would be available to an ordinary company

4.130 For example, if an AHC were permitted to own UK property, regime rules would need to provide for cases where this was held alongside other investments. AHCs might need to stream income and expenses so that deductions, for example in respect of interest payments on results dependent debt, could not be set against any UK property business income or gains on UK property or UK property rich assets.

4.131 The government would also need to consider what situations might arise where the relief available to AHCs against gains could allow expenses which might otherwise have been set against such gains to reduce taxable profits in relation to UK property, and whether there is a need for rules to protect against that.

Question 34: To protect against the risk of loss of tax on UK property income and gains, do you think it would be appropriate for regime rules to specify that an AHC should not own UK land or UK property rich assets? To what extent could this discourage use of AHCs for multi-jurisdictional real estate funds?

Question 35: If the regime permitted AHCs to own UK land and UK property rich assets, how could rules ensure that the additional deductions and reliefs available to an AHC did not lead to any erosion of the UK tax base in UK property?

Stamp Duty and SDRT

4.132 The government intends to explore providing a Stamp Duty exemption where an AHC repurchases its own shares in order to return capital to investors. More generally, the government will explore whether there is scope for broader exemption from Stamp Duty and Stamp Duty Reserve Tax (SDRT) on some or all transfers of shares and loan capital in an AHC.

4.133 Any changes would need to consider the potential for abuse or loss of existing tax revenues. For example, if an exemption applied in cases where the transaction represented the sale of a UK company that is an investment asset of the AHC, this could create a more favourable result than if investors had disposed of the UK company directly, in which case Stamp Duty or SDRT would have been charged on the transaction.

4.134 The government welcomes views on the impact of Stamp Duty and SDRT on AHC location. In particular, the government would be keen to hear whether the following would have a significant impact when deciding whether to locate an AHC in the UK:

- The existence or absence of a Stamp Duty loan capital exemption. What provisions of the current exemption would cause problems and why? For example, to what extent would the use by AHCs of results dependent debt cause difficulties in the absence of a Stamp Duty exemption?
- Stamp Duty and SDRT charges on the transfer of AHC shares, including but not limited to situations where an AHC repurchases its own shares
- Any other situation where a Stamp Duty or SDRT charge could arise

Question 36: How significant is the impact of Stamp Duty and SDRT on AHC location, in particular with reference to the points listed at paragraph 4.134? Please provide details of the specific situations where the lack of an exemption would have a significant impact when deciding whether to locate an AHC in the UK.

Hybrid mismatches

4.135 It is recognised that the special rules for AHCs, which will be necessary in order to deliver the high level policy objectives of the regime, will cause payments both to and by AHCs to have the potential to be subject to counteractions under the UK's hybrid mismatch rules as they are currently drawn. Accordingly, it is intended that the UK's hybrid mismatch rules will be disapplied in relation to such payments to the extent needed to meet those policy objectives.

4.136 Where AHCs either receive payments from, or make payments to, entities in other jurisdictions, the local treatment of those payments will of course depend on the law of the relevant jurisdictions.

Corporate groups

4.137 The government believes that it will be necessary to amend the application of rules relating to corporate groups for the purposes of group relief.

4.138 In general, companies can surrender losses to other companies within the same group relief group, on the basis that the group should be seen for these purposes as a single economic unit.

4.139 However, given the additional deductions and reliefs allowed for an AHC and its status as part of an investment fund structure, the government does not believe it would be appropriate for an AHC to surrender or claim losses as group relief.

Question 37: Do you have views on the government's proposed approach to group relief for AHCs?

Question 38: Are there other rules relating to corporate groups whose application you think should be modified for AHCs?

Entry and exit from the regime

4.140 The government proposes that to qualify as an AHC for an accounting period, a company should make an election as part of its Company Tax Return. This will enable monitoring and prevent inadvertent entry to the regime.

4.141 The company may be a new company established for the purposes of the AHC regime. However, there may also be circumstances where a company already used to hold investment assets wishes to become an AHC. The government would like to understand how common these circumstances might be, whether they should be accommodated and what issues they might present. We would need to consider any increased risks of abuse or avoidance and how these could be protected against.

4.142 The government anticipates that a company may exit the AHC regime because it

- Is wound up
- Is sold
- Intentionally or unintentionally ceases to meet eligibility criteria, or
- Simply chooses to exit

4.143 On any of these events, it will be necessary to ensure that the transition does not cause any amounts to fall out the scope of tax. For example, any gains not yet charged to tax, reinvested or returned to investors should become taxable. This could be achieved via a deemed disposal from the perspective of the investors or via a charge in the AHC.

4.144 In addition, rules may need to prevent a company from carrying losses it incurred as an AHC forward or backward into accounting periods where it is or was outside the regime. If an AHC has incurred losses in relation to, for example, payments on results dependent instruments, these amounts should not be available to set against taxable income of any company outside the regime.

4.145 If a company that has claimed the benefits of the AHC regime is wound up and is subsequently found not to have met eligibility criteria, significant additional tax may be due. The government would welcome views on how to ensure this can be collected.

Question 39: Should the regime accommodate entry by companies already used to hold investment assets prior to becoming AHCs? What issues could arise for these companies? How could regime rules protect against any increased risks of abuse or avoidance?

Question 40: In situations where a company leaves the AHC regime, how can regime rules provide against loss of tax? For example, what is the best way to ensure that gains not yet charged to tax, reinvested or returned to investors become taxable? Should this be via a deemed disposal from the perspective of the investors or via a charge in the AHC?

Question 41: Where a company that has claimed the benefits of the AHC regime is wound up and is subsequently found not to have met eligibility criteria, what is your view on the best method to ensure that any additional tax due can be collected?

Accounting periods

4.146 It may be appropriate for a new accounting period to begin for tax purposes at the point when a company enters the regime. If the company subsequently exits the regime, it may similarly be appropriate for a new accounting period to begin for tax purposes on the first day the company is no longer an AHC.

Question 42: Should a new accounting period begin for tax purposes when a company enters or exits the AHC regime?

Temporary breaches

4.147 The government is interested to understand whether any situations may arise where an AHC ceases to meet the regime eligibility conditions for a temporary period. For example, we would like to know whether sale of an AHC from one set of qualifying owners to another could cause it to fail the conditions around the time of the transfer.

Question 43: Can you provide details of any situations where an AHC might temporarily cease to meet the regime eligibility conditions? How should regime rules approach situations of this type?

Other tax issues

4.148 The government would be interested to understand more about the specific concerns relating to the following areas, where respondents suggested that current rules may act as a barrier to locating asset holding companies in the UK:

- The controlled foreign companies (CFC) rules
- The corporate interest restriction (CIR)

- The employment related security (ERS) rules
- The exemptions from corporation tax available for distributions and
- Treatment of fair value movements on loans and derivatives

4.149 The government would also welcome views on any other issues that should be considered in design of a regime for AHCs. These could include the tax treatment of investors who invest via a UK AHC as well as tax treatment of the AHC itself. The government would like to receive evidence on the extent to which any such issue could affect take-up of an AHC regime, as well as suggestions for how it could be addressed.

4.150 We would also like to receive details of specific examples of existing, overseas companies fulfilling the role of an AHC, in order to test the full effects of the proposed regime and of draft legislation.

Question 44: What situations are there where current rules in any of the areas listed at paragraph 4.148 could act as a barrier to locating AHCs in the UK? Are there any other issues the government should consider in this regard? Please provide information to illustrate the extent to which these issues could affect take-up of an AHC regime.

Question 45: How should any issues identified in your answer to Question 44 be addressed?

Question 46: Can you provide specific examples of existing overseas companies fulfilling the role of an AHC, in order to test the full effects of the proposed regime and of draft legislation?

Anti-avoidance

4.151 The government will seek to protect any new regime for AHCs from risks of abuse or avoidance. We perceive the main risks relating to an AHCs regime as:

- Co-option to serve the interests of entities other than the intended beneficiaries of the regime
- Loss of tax when vehicles exit the regime
- Conversion of income to capital in the hands of investors, and
- Misuse of the regime to escape tax due in other jurisdictions

4.152 The government welcomes views on the level and best approach to risks in these areas, and on any other risks that may be associated with the regime proposed above.

Question 47: Please highlight any inherent features of the proposed regime that you consider protect it against abuse, and set out what additional anti-avoidance rules you consider might be desirable.

Reporting and monitoring

4.153 If a new regime for AHCs is instituted, the government will wish to understand how it is being used, both to inform further policy work in the area of fund taxation and to monitor for any risks of abuse. In addition, the government believes that it will be to the advantage of those who use the regime if HMRC has clear information available to establish that their activities are low risk from the perspective of tax compliance.

4.154 The government therefore proposes that AHCs be required to provide a specified set of information as an additional element of the Company Tax Return.

4.155 The government would also welcome suggestions for an XBRL taxonomy for these items, and views on whether tagging would be a convenient and reliable method to ensure that the information is provided.

4.156 Information returned could cover points such as the following:

- Date AHC joined the regime
- Asset manager, their UK tax reference if applicable, and the jurisdiction where they are registered/authorised and supervised
- Asset class or classes invested in
- Value of portfolio at most recent valuation
- Proportion of portfolio comprised of assets situated outside the UK
- Proportion of income received in the AP arising from sources outside the UK
- Paid up share capital
- Face value of debt issued to investors
- Face value of debt issued to third parties
- Gains realised since joining regime
- Gains reinvested since joining regime
- Gains returned to investors since joining regime, and
- If the AHC leaves the regime during the AP, date of exit

Question 48: What information, either listed in paragraph 4.156 or otherwise, do you think HMRC should collect to maintain the AHC regime as low risk and provide a high-level understanding of how it is used?

Question 49: Do you have suggestions for an XBRL taxonomy for these items? What are your views on whether tagging would be a convenient and reliable method to ensure that information is provided?

Chapter 5

Consultation on changes to the REIT regime

5.1 The responses to the initial Asset Holding Companies consultation, set out in the summary of responses section, noted a number of areas where the REIT regime could be reformed, to remove unnecessary barriers, including for use as an AHC. The government intends to explore the proposals made in the responses as well as any other suggestions for making the REIT regime more attractive for investors.

5.2 Whilst a comprehensive review of the REIT rules is intended to form part of the wider funds review, stakeholders have suggested that there are a number of changes that could be made alongside the introduction of the AHC rules and that would have immediate benefits in making the UK a more competitive location for holding real estate assets. On this basis, the government is now consulting further on the areas set out below to the same timetable as the consultation on delivery of a new regime for AHCs.

Listing requirement

5.3 The government recognises that the requirement to be listed or traded on a recognised stock exchange can create unnecessary and costly administrative burdens in some circumstances, such as where a REIT is wholly owned by institutional investors. The government is considering relaxing this requirement where the institutional investors are themselves widely held, and welcomes views on the scope of the relaxation and where the boundary should be drawn. For example, an option could be to require a minimum percentage holding by widely held institutional investors, so that harsh cliff edges are avoided, but the rules would still encourage interests in REITs to be made available to a wide range of investors.

5.4 The government is not currently minded to remove the listing requirement completely but welcomes representations on the benefits and risks of any complete removal.

Question 50: Who should any relaxation of the listing requirement apply to? If there is a relaxation for institutional investors, how could this be applied? What are the benefits and risks of applying a relaxation where institutional investors hold less than 100% of the REIT and where should any cut off point be set if relaxing the requirement for REITs only partly held by institutional investors?

Question 51: What would be the benefits and risks of a complete removal of the requirement for listing?

Institutional investors and the close company requirement

5.5 The rules on the close company requirement were relaxed in 2012, so that a close company could enter the REIT regime where it is close only because it has an institutional investor as a participator. The government intends to explore further the following areas:

- Some respondents said that the list of institutional investors should be kept under review, and the addition of further investor types considered. The government welcomes views on which types of investors should be added to the list.

- Responses proposed using a similar look through approach to that in NRCGT rules in Schedule 5AAA TCGA 1992 when determining whether a company is close. For example, a company would not be considered as close where it is wholly owned by a corporate vehicle that is in turn owned by an institutional investor. The government will consider such a change and, as part of any reforms, will also consider introducing a requirement to be widely owned to apply to certain investor types in the list of institutional investors, as is the case for the NRCG rules.

- The rule for an overseas equivalent of a UK REIT refers to the overseas REIT regime being equivalent rather than the overseas entity. The government will consider representations on the benefits and any risks that may arise from modifying the requirement so that it suffices that the overseas entity would qualify as a UK REIT were it to be UK resident. Representations should consider how HMRC could obtain sufficient assurance that any particular overseas entity satisfies the requirement.

Question 52: Are there any further investor groups who should be added to the list of institutional investors? Why should these investors be added, including the expected impact and are there any additional tax issues that would need to be considered?

Question 53: When considering a look through approach as part of the close company test, should this work in a similar way to the NRCGT rules or would this need to be modified to work with the REIT rules? If the rules would need to be modified, what changes should be made?

Question 54: Would a change to the rules for overseas equivalents of a REIT encourage overseas investment through UK REITs? What difficulties may there be in establishing that an overseas company satisfies the requirement to be equivalent? Are there any risks arising from such a change?

Holders of excessive rights rule

5.6 As noted in the summary of responses, this rule gives rise to a tax charge on a REIT that makes distributions to shareholder holdings of 10% and greater. The government is aware that this leads to certain investors in REITs needing to fragment their shareholdings, creating complicated and costly structures solely to remain under the 10% limit, even where those investors are entitled to receive gross property investment distributions.

5.7 The government will consider relaxing this rule so that it would apply only on distributions to entities where withholding tax would be required, resulting in no tax charge under this rule where the recipient is entitled to receive distributions gross. The rule would still be required for other investors to ensure that property income is taxed appropriately.

Question 55: Are there any different ways in which this rule could be changed that should be considered? If so, please explain how, the reasons for such changes, and identify the impacts and risk.

The balance of business test

5.8 This test requires that 75% of a REIT's assets and income derive from property investment assets. The test therefore implicitly recognises that some REITs undertake other activity, such as property development (either as an integral part of their business, or as a result of a regulatory or planning requirement such as 'Section 106' planning obligations).

5.9 Responses have made it clear that many see the test as burdensome and potentially unfair in its operation, for example where an anomalous or unexpected transaction or event arises in one or more years. The government will consider how the test can be reformed to provide greater certainty. Suggestions made in responses included:

- Excluding overseas property holdings to attract more pan-European REITs to the UK (recognising that this could have a positive or negative impact on the test depending on the circumstances)
- Using a 3-year average to avoid failure due to anomalous or unexpected transactions
- Treating activities arising purely as result of regulatory or planning requirements as 'good' activities for the test
- Introducing a gateway test based on consolidated accounts, with failure to meet the initial test requiring application of the more detailed test

5.10 The government will consider which of these reforms, or combinations of them, would reduce the burden of the test. Any changes will need to be well targeted and simple to apply in practice.

Question 56: Which of the reforms suggested, or combinations of them should be considered? Are there any other ways in which the balance of business rules could be reformed in order to reduce burdens while maintaining the principles of the REIT regime? How might these apply in practice?

Wider funds review

5.11 The government will take forward the other points included within the summary of responses for REITs as well as other areas of the REIT regime that may benefit from reform as part of the wider funds review. These will be detailed in the call for input for the wider funds review which will be published shortly, along with a request for responses on any other REIT regime reforms that the government ought to consider.

5.12 The government will engage with stakeholders on the treatment of multi-jurisdictional property funds. Responses to the first AHC consultation (see paragraphs 2.96-2.106) included the suggestion that the REIT regime could be used for holding multi-jurisdictional property. The responses also highlighted that a barrier to this is the requirement to deduct withholding tax from property income distributions to investors, which is in addition to any tax paid in the property jurisdiction.

Chapter 6
Questions

Consultation on delivery of a new regime for AHCs

Eligibility

Question 1: Do you think an AHC regime should include arrangements where some or all investors invest directly at the level of the AHC, as discussed at paragraph 4.25? Can you provide evidence on how common these arrangements are?

Question 2: Are there situations where legal agreements involving investors who invest directly at the level of the AHC are significantly different from those where all investors invest through a CIS or AIF? For example, would different investors' interests be fungible under these arrangements or could there be differences in the way some investors participate in the results of investments?

Question 3: Would a broader approach to eligibility, accommodating arrangements of the type discussed in Question 1, create increased risks of abuse or avoidance? If so, how could these be mitigated?

Question 4: Is the concept of participation a suitable way to identify the investors in an AHC? Would this be consistent with the commercial reality of investment arrangements? Do you have any suggestions for an alternative approach, for example referring to the legal documents used to determine the rights of investors?

Question 5: How can regime rules accommodate structures where companies fulfilling the role of an AHC are not directly owned by the ultimate investors or by another AHC?

Question 6: What is the best method to identify the asset manager who provides investment management services to investors in relation to the investments held by an AHC? Do you foresee complications, for example in a structure with multiple layers of AHCs? How can regime rules address these situations?

Question 7: What tests would best ensure that investment decisions are taken by an asset manager who is subject to regulation and has genuine independence from the investors?

Question 8: What would be an appropriate maximum proportion for asset managers' interests in an AHC, including interests held by individual fund executives? Can you provide details of relevant commercial arrangements?

Question 9: How should regime rules ensure that the activities of an AHC are limited to a facilitative, intermediate role between investors and investments?

Question 10: Can you provide evidence about any specific situations where, as part of an AHC's facilitative, intermediate role and for genuine commercial reasons, part of its activity might amount to a trade?

Question 11: Should eligibility criteria include the requirements set out at paragraph 4.49?

Question 12: How could regime rules safeguard against assets and/or related income being ring-fenced for the benefit of a subset of investors?

Question 13: Could the proposed approach to eligibility include arrangements that you believe should not be included within an AHC regime?

Question 14: Could the proposed approach to eligibility exclude arrangements there is a good rationale to include within the regime? If so, how might relevant structures be defined? Are there structures designed to facilitate alternative finance arrangements that could be excluded?

Profit on income received by an AHC

Question 15: Can you provide evidence as to the methods and instruments an AHC might use to return income and capital sums to investors and the commercial, administrative and tax considerations that will inform this choice?

Question 16: What advantages or disadvantages could there be in allowing a broader range of deductions to calculate an AHC's profits? Do you consider that the better alternative would involve deductions for specific instruments? Or do you think the regime should take a broader approach based on the totality of amounts returned to investors?

Question 17: To what extent would the outcomes discussed in paragraph 4.65-4.68 be appropriate for AHCs, and to what extent do the rules contemplated as part of the regime make these outcomes more likely? If such outcomes are inappropriate, how can regime rules ensure that an AHC is subject to tax on a suitable measure of profit on taxable income?

Question 18: What is your view on the best method to ensure that an AHC cannot obtain relief for any payments to investors that would reduce its profit below an amount commensurate with its role?

Question 19: Can you provide information on how funds approach transfer pricing for any instruments where deductions are not currently available in the UK? Can you provide examples from existing companies fulfilling the role of an AHC to illustrate any areas of potential difficulty?

Capital gains realised by an AHC

Question 20: Will the proposed treatment of capital gains realised by an AHC provide an effective means of ensuring that AHCs do not pay tax on gains they reinvest or return to investors?

Question 21: Could the relationship between the relief proposed for gains and other potential reliefs available to an AHC create undue complexity or unintended consequences?

Question 22: How could rules on relief for gains be protected from abuse in a way that is simple and easy to administer? Would a requirement of the kind discussed under 'Eligibility', that AHCs have a policy or practice of reinvesting or returning capital to participants when investment assets are sold, help achieve this aim?

Withholding tax on payments of interest to investors

Question 23: To what extent could a WHT exemption for payments of interest by AHCs to investors create risks around the diversion of investment income to low tax territories?

Question 24: How could regime rules mitigate these risks? Do you think any WHT exemption for AHCs should include a purpose test and/or be limited to interest paid to recipients in qualifying territories?

Income and gains paid to investors

Question 25: How can regime rules ensure that amounts of income returned to investors are treated appropriately for the purposes of UK tax?

Question 26: What is your view on the most appropriate method to treat amounts as capital gains in the hands of investors?

Question 27: How should regime rules ensure that amounts designated as gains cannot displace amounts that should be treated as income in the hands of investors?

Question 28: How can an investor's interest in the AHC be appropriately valued in order to determine their proportionate share of any gains? What instruments might investors hold, with what rights attached, and how might these holdings change over time?

Question 29: Are there other areas of the tax code that could counteract the intended effect of rules to treat amounts as gains in the hands of investors or produce unintended consequences?

Question 30: How could rules to treat amounts as gains in the hands of investors be protected from abuse? Is there a streamlined test the regime could use to safeguard against conversion of income to capital?

Question 31: Should the regime allow certain types of profit on loan relationships of an AHC, such as profit on redemption or disposal of 'distressed' debt, to be treated as capital? Is there an appropriate method that could be used for this purpose?

Real Estate

Question 32: Can you provide evidence on the number and type of situations where a fund might wish to use UK SPVs to own and receive overseas property income directly?

Question 33: Given the availability of relief in the UK for foreign tax paid, to what extent would the lack of an exemption for overseas property income act as a barrier to the use of UK AHCs to hold overseas property? Can you provide any examples of specific situations affected by this issue? To what extent would this affect the choice to locate master and intermediate holding companies in multi-jurisdictional real estate funds in the UK?

Question 34: To protect against the risk of loss of tax on UK property income and gains, do you think it would be appropriate for regime rules to specify that an AHC should not own UK land or UK property rich assets? To what extent could this discourage use of AHCs for multi-jurisdictional real estate funds?

Question 35: If the regime permitted AHCs to own UK land and UK property rich assets, how could rules ensure that the additional deductions and reliefs available to an AHC did not lead to any erosion of the UK tax base in UK property?

Stamp Duty and SDRT

Question 36: How significant is the impact of Stamp Duty and SDRT on AHC location, in particular with reference to the points listed at paragraph 4.134? Please provide details of the specific situations where the lack of an exemption would have a significant impact when deciding whether to locate an AHC in the UK.

Corporate groups

Question 37: Do you have views on the government's proposed approach to group relief for AHCs?

Question 38: Are there other rules relating to corporate groups whose application you think should be modified for AHCs?

Entry and exit from the regime

Question 39: Should the regime accommodate entry by companies already used to hold investment assets prior to becoming AHCs? What issues could arise for these companies? How could regime rules protect against any increased risks of abuse or avoidance?

Question 40: In situations where a company leaves the AHC regime, how can regime rules provide against loss of tax? For example, what is the best way to ensure that gains not yet charged to tax, reinvested or returned to investors become taxable? Should this be via a deemed disposal from the perspective of the investors or via a charge in the AHC?

Question 41: Where a company that has claimed the benefits of the AHC regime is wound up and is subsequently found not to have met eligibility criteria, what is your view on the best method to ensure that any additional tax due can be collected?

Question 42: Should a new accounting period begin for tax purposes when a company enters or exits the AHC regime?

Question 43: Can you provide details of any situations where an AHC might temporarily cease to meet the regime eligibility conditions? How should regime rules approach situations of this type?

Other tax issues

Question 44: What situations are there where current rules in any of the areas listed at paragraph 4.148 could act as a barrier to locating AHCs in the UK? Are there any other issues the government should consider in this regard? Please provide information to illustrate the extent to which these issues could affect take-up of an AHC regime.

Question 45: How should any issues identified in your answer to Question 44 be addressed?

Question 46: Can you provide specific examples of existing overseas companies fulfilling the role of an AHC, in order to test the full effects of the proposed regime and of draft legislation?

Anti-avoidance

Question 47: Please highlight any inherent features of the proposed regime that you consider protect it against abuse, and set out what additional anti-avoidance rules you consider might be desirable.

Reporting and monitoring

Question 48: What information, either listed in paragraph 4.156 or otherwise, do you think HMRC should collect to maintain the AHC regime as low risk and provide a high-level understanding of how it is used?

Question 49: Do you have suggestions for an XBRL taxonomy for these items? What are your views on whether tagging would be a convenient and reliable method to ensure that information is provided?

Consultation on changes to the REIT regime

Listing requirement

Question 50: Who should any relaxation of the listing requirement apply to? If there is a relaxation for institutional investors, how could this be applied? What are the benefits and risks of applying a relaxation where institutional investors hold less than 100% of the REIT and where should any cut off point be set if relaxing the requirement for REITs only partly held by institutional investors?

Question 51: What would be the benefits and risks of a complete removal of the requirement for listing?

Institutional investors and the close company requirement

Question 52: Are there any further investor groups who should be added to the list of institutional investors? Why should these investors be added, including the expected impact and are there any additional tax issues that would need to be considered?

Question 53: When considering a look through approach as part of the close company test, should this work in a similar way to the NRCGT rules or would this need to be modified to work with the REIT rules? If the rules would need to be modified, what changes should be made?

Question 54: Would a change to the rules for overseas equivalents of a REIT encourage overseas investment through UK REITs? What difficulties may there be in establishing that an overseas company satisfies the requirement to be equivalent? Are there any risks arising from such a change?

Holders of excessive rights rule

Question 55: Are there any different ways in which this rule could be changed that should be considered? If so, please explain how, the reasons for such changes, and identify the impacts and risk.

The balance of business test

Question 56: Which of the reforms suggested, or combinations of them should be considered? Are there any other ways in which the balance of business rules could be reformed in order to reduce burdens while maintaining the principles of the REIT regime? How might these apply in practice?

HM Treasury contacts

This document can be downloaded from www.gov.uk

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Annex A
List of respondents

- All Party Parliamentary Group on Anti-Corruption and Responsible Tax
- Alternative Credit Council
- Alternative Investment Management Association
- Aviva Investors
- BDO LLP
- Blackrock
- British Property Federation
- British Venture Capital Association
- Deloitte LLP
- DLA Piper LLP
- Ernst & Young LLP
- Eversheds Sutherland LLP
- FTI Consulting LLP
- Global Infrastructure Investor Association
- Herbert Smith Freehills LLP
- INREV
- IPSX
- KPMG LLP
- Legal & General Plc
- Macfarlanes LLP
- Managed Funds Association
- Ocorian
- Ontario Teachers’ Pension Plan
- Paul Hastings LLP
- Permira Advisors LLP

- PricewaterhouseCoopers LLP
- PSP Investments
- RSM UK Tax and Accounting Ltd
- Sanne Group
- Segro Plc
- The Association of Investment Companies
- The Association or Real Estate Funds
- The Investment Association
- The Investment Property Forum
- The Law Society
- TheCityUK
- Travers Smith LLP
- White & Case LLP