HM Treasury

Tax treatment of asset holding companies in alternative fund structures:

consultation

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public.enquiries@hmtreasury.gov.uk

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Chapter 1
Introduction

General background

1.1 Asset management firms manage the savings and pensions of millions of UK citizens. They raise capital from investors and allocate it across the wider economy. 75% of UK households use an asset manager's services either directly or indirectly (for example through workplace pensions).

1.2 The UK asset management sector is the largest in Europe and the second largest globally, with around £9.1 trillion assets under management. The industry makes an invaluable contribution to the UK economy, generating significant employment and tax revenue. There are 39,500 people working directly for asset management firms in the UK, with a further 76,000 jobs in areas that support or result from asset management activity. The Investment Association estimated that the sector contributed at least £4.5 billion in taxes in 2016 to 2017.

1.3 The government is committed to the ongoing success of the asset management industry, so that it continues to thrive and provide the best possible outcomes for consumers, for businesses, and the UK economy.

1.4 That is why the government established the Asset Management Taskforce, which was introduced to enhance dialogue between the government, the regulator, and industry. The government welcomes ongoing engagement from the Taskforce and from the asset management industry more widely, including the 2019 UK Funds Regime Working Group Report produced by the Investment Association at the request of the Taskforce. The recommendations made in the Report, as well as other industry representations, will inform the development of a wider review of the UK funds regime.

Consultation outline

1.5 As announced at Spring Budget 2020, the government is pursuing a review of the UK funds regime. This review will consider taxation and relevant areas of regulation to ensure the ongoing competitiveness and sustainability of the UK regime as it applies to a fundamental area of the financial services sector.

1.6 As an opening step of the review, the government has made two specific announcements at Spring Budget 2020. The first is a review of the VAT charged on fund management fees. The second is this consultation, which seeks to gather evidence and explore the attractiveness of the UK as a location for the intermediate entities through which alternative funds hold fund assets.

1.7 In terms of background, the government understands from engagement with industry and their advisers, that despite the general attractiveness of the UK corporation tax system for holding company structures, there remain barriers to the establishment of these intermediate fund entities in the UK.

1.8 The government is aware that these barriers, which do not exist in some other jurisdictions, are leading these entities to be located outside of the UK. That is despite the wider strengths of the UK as a financial services hub and despite significant demand from funds to be able to locate these entities alongside UK fund management activities for reasons of commercial efficiency.

1.9 Finally, it is also understood that within the industry there is a view that these barriers could be addressed through low cost, targeted changes that are consistent with the principles underpinning the UK corporation tax system and consistent with the UK's more general approach to funds taxation.

1.10 This consultation looks to improve the government's understanding of these intermediate entities within fund structures – hereafter named asset holding companies (AHCs) - the fund structures in which they are commonly used, the commercial drivers of their location and the fiscal and economic benefits that they bring to the jurisdiction in which they are located.

1.11 It then explores the barriers that the UK corporation tax system might be creating for the establishment of these companies in the UK, the merits of taking steps to remove those barriers, and the different options that might exist for doing so.

Principles guiding this consultation

1.12 The government is prepared to make legislative changes in response to this consultation, subject to evidence that those changes will bring clear benefits by facilitating the flow of capital, income and gains between investors and underlying investments via UK AHCs.

1.13 The government is not prepared to make changes that take significant amounts of existing UK taxable income and or gains out of the scope of taxation in a way that is inconsistent with the principles of the UK tax system. Nor is it prepared to make changes that create unprotected risks of abuse and avoidance.

1.14 Any changes made in response to the consultation will need to be consistent with the UK's continued commitment to fully adhere to international tax standards, for example the OECD's Base Erosion and Profit Shifting minimum standards, including global standards on fair tax competition as governed by the OECD's Forum on Harmful Tax Practices (FHTP). The changes will need to be consistent with the UK's commitments to ensure a tax system that does not discriminate between legally comparable operators.

Timing

1.15 The consultation will run until May 20th.

1.16 The government will then decide on the merits of action, and if relevant, the legislative timetable. While the government recognises the demand for near-term changes in this area, this will ultimately depend on the nature of such changes and extent to which there needs to be further consultation.

1.17 Further detail on the wider review of the UK funds regime will be published in due course.

How to respond

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

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

1.20 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
Understanding the Policy Concern

Background to the issue

2.1 In general, the UK has a highly competitive corporation tax regime for holding companies within a group or investment structure.

2.2 That reflects its extensive network of double tax treaties, a comprehensive distribution exemption, no dividend withholding tax, broadly available exemptions from withholding tax on corporate interest, a wide exemption for gains on disposals of substantial shareholdings and, at 19%, the lowest corporation tax rate in the G20.

2.3 Despite this, the government has been made aware of concerns that the UK corporation tax rules act as a barrier to the establishment in the UK of holding companies within certain investment fund structures.

2.4 It understands that these barriers may be leading these companies to be located outside of the UK, despite the UK's wider strengths as a financial services location and the commercial benefit that funds see to locating these companies alongside UK fund management functions.

Important considerations

What are the relevant fund structures?

2.5 One of the objectives of the consultation is to better understand what these barriers are and what investment fund structures they are most relevant to.

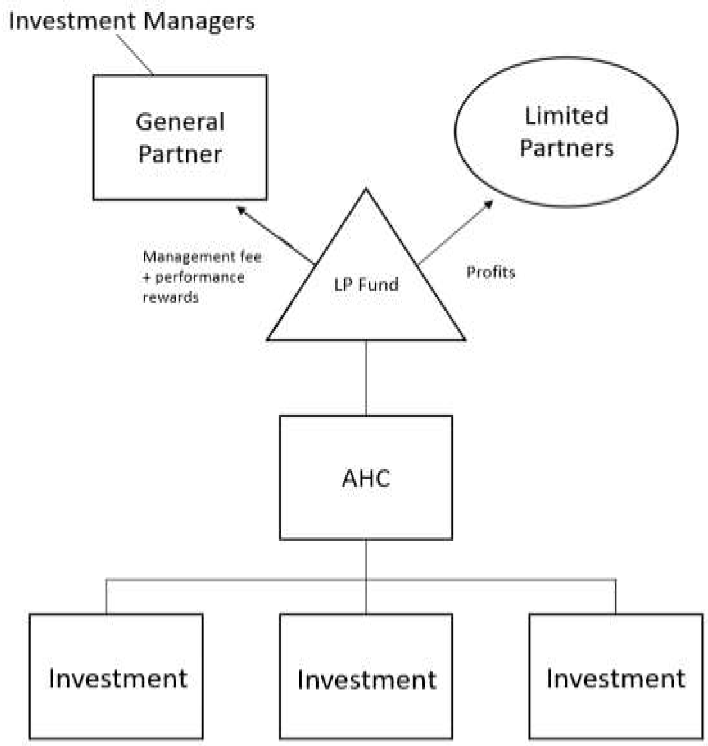
2.6 It is the government's understanding that issues relating to AHCs are of most relevance to alternative funds that commonly make real-estate, credit and private equity investments through intermediate companies.

2.7 Alternative funds, otherwise referred to as non-CIV funds, as defined by the OECD, are generally understood to be funds that, despite existing to raise capital from investors for the purposes of generating investment returns, are not subject to investor-protection regulation in the same way as other collective investment funds.

2.8 They are generally closed-ended funds that raise capital from sophisticated investors, typically pension funds, insurance companies and sovereign wealth funds, among others, and then invest that capital in more illiquid and higher risk assets for a defined period.

2.9 These funds commonly pool investor capital through a limited partnership, with the limited partners being the investors in the fund and the general partner being the investment manager. This pooled capital is then invested –

whether in corporate equity, debt or real-estate – through one or more special purpose vehicles which we term in this consultation asset holding companies (AHCs).



2.10 This consultation seeks views on whether this is an appropriate characterisation of alternative funds and whether there are other funds or collective investment structures for which such indirect investment is similarly relevant.

What is the role of AHCs within these structures?

2.11 The government would like to better understand the role of AHCs within these fund structures and the commercial and tax drivers behind their location. Representations have identified different commercial purposes for the use of AHCs within these fund structures. These include:

a) Giving the fund greater control over its distribution and reinvestment policies;

b) Limiting the liability of the partners in the fund;

c) Allowing for co-investment or third-party borrowing at a level that relates more closely to a specific underlying investment;

d) Reducing the administrative burdens that would arise from direct fund investment, including the administrative challenges in end investors claiming treaty benefits to which they would be entitled if directly invested.

2.12 The government understands that tax is not the principal driver behind the interposition of AHCs in the structure. However, it also understands that funds will look to locate AHCs in countries that do not impose additional layers of tax on through-bound investment flows, which would otherwise create a wedge between direct and indirect investment and outweigh the benefits cited above.

What is the benefit of AHCs being located in the UK?

2.13 The government would also like to understand the potential direct and indirect benefits to the UK that would flow from an increase in AHCs located here.

2.14 Engagement with industry has suggested that there would be direct fiscal benefits to the UK from proportionate taxation of these AHCs. While their functions and role within the fund structure might only justify a small margin, it is suggested that the taxation of this margin across a high number of AHCs, as well as the taxation of linked employment income, could generate material revenue for the Exchequer.

2.15 It has also been argued that there would be indirect benefits flowing from an increase in AHCs in the UK, including an increase in supporting infrastructure (e.g. legal advice, accounting advice) that will generate fees and employment income that falls within the UK tax net and has multiplier effects in the UK economy.

2.16 Finally, representations made to government have also argued that, in the absence of action, there is a risk that funds shift existing UK management activities overseas to consolidate their presence in other jurisdictions and increase the commercial efficiency and viability of their overall structures.

2.17 The government would like to explore these drivers for change and be provided with practical examples that illustrate the potential benefits to the economy and the Exchequer and how those benefits compare with the possible costs and risks associated with reform.

Chapter 3

Challenges to the UK as a domicile

3.1 Several challenges to locating AHCs in the UK have been raised. These include specific issues in relation to credit, real-estate, and private equity funds, as well as the UK's general treatment of withholding tax on interest and the impact of the hybrid mismatch rules.

3.2 The government is interested in understanding the scale of these challenges and how they could be addressed through targeted changes that maintain the integrity of the UK's tax system in a way that would not affect or lower adherence to international tax standards.

Credit Funds

3.3 The government understands that credit funds typically invest in debt securities, or originate loans, through one or more intermediate companies.

3.4 It is understood that these AHCs are generally located in countries that ensure taxation on a simple financing margin, that corresponds to the basic function they perform and their role of passing on investment income – interest income, pull to par gains, and origination fees – to the fund and its investors.

3.5 It has been suggested to the government that current corporate tax rules act as a barrier to credit funds establishing these AHCs in the UK, due to the difficulties in structuring arrangements such that these companies are taxed on a measure of profit commensurate with their economic activities.

3.6 That reflects the difficulties for credit funds in structuring back-to-back lending arrangements that seek to match notes issued to the fund with third-party investments. It also reflects the UK distribution rules which, for sound policy reasons, limit relief for coupons that vary depending on the performance of an underlying investment portfolio.

3.7 The government is seeking to understand more about these challenges and the extent to which they are unique to the UK. It is also seeking views on how these issues could be addressed, and the approaches that have been taken in other countries for overcoming them.

3.8 For example, it has been suggested that AHCs within credit funds can benefit from the bespoke securitisation tax regimes available in other jurisdictions, which ensure qualifying companies are taxed on a margin in line with their role within the overall arrangement.

3.9 It has then been proposed that modifications to the eligibility criteria for the UK's Taxation of Securitisation Company Regulations (TSCR) – for example the £10 million issue threshold and the permitted activities and financial assets of the securitisation vehicle - would allow AHCs within credit funds to similarly avail themselves of the securitisation tax regime in the UK and make the UK a viable AHC location.

3.10 The government has reservations about this approach, given the vital importance of regime stability for users of existing securitisation arrangements. However, it remains open to further discussion on this issue.

Real-estate funds

3.11 The government understands that real-estate funds commonly invest in real-estate assets through one or more intermediate companies. These are generally located in countries that avoid additional layers of tax as property returns are realised and passed back to the fund and its investors. Typically, that means a country with an extensive double tax treaty network, a broad exemption for share disposal gains, and the absence of withholding tax on distributions.

3.12 The UK performs strongly against these criteria, but it has been suggested that there remain barriers to AHCs within real-estate funds being located in the UK.

Substantial Shareholding Exemption

3.13 Stakeholders have identified the accessibility of the Substantial Shareholding Exemption (SSE) for real estate funds as one such barrier. The UK has operated a broad exemption for gains made by companies on the disposal of substantial shareholdings since 2002.

3.14 In 2016 the government responded to concerns aired by stakeholders and reformed the SSE. Changes included removing the condition that the investor company is trading to benefit from the exemption and removing the condition that the investee company is trading where the investor is more than 80% owned by qualifying institutional investors (QIIs).

3.15 The reforms sought to make the UK a more attractive location for holding companies, particularly those within tax-exempt institutional investment structures, such as investment holding companies owned by pension funds.

3.16 These changes benefit certain institutional investors in real-estate. However, the changes are of less benefit to AHCs within real-estate funds that have a mixed investor profile of tax-exempt QIIs and non-exempt investors, given that such funds may face difficulties in ascertaining the QII percentage as well as the uncertainty that the percentage could change over the fund's term.

3.17 The government would like to better understand these concerns and consider whether further reforms might make the UK a more attractive location for AHCs within real-estate funds.

3.18 Different proposals have been put forward in representations made by industry. These include:

a) **Expansion of the QII rules:** Broadening the qualification for inclusion into the rules;

b) **Creating a more comprehensive exemption:** This would involve transitioning to a broader participation exemption through removing the trading conditions at investee level. Options may involve excluding disposals of UK property rich companies to recognise the importance of ensuring disposals of UK property remain within the scope of UK tax and the impact the Non-Resident Capital Gains rules have had in addressing the competitive imbalance between UK property investments made from the UK or overseas.

3.19 There will be a need to critically examine the fiscal implications of any representation made in respect of the SSE against the main policy intention of the exemption, and consider the extent to which viable options could be protected against the behavioural risks identified in the 2016 consultation, for example the tax-motivated enveloping of a business's productive assets to allow for tax-free disposal.

Other considerations

3.20 Alongside the tax treatment of capital gains, the government is interested in understanding whether the treatment of rental income flows through a UK-based AHC in a real-estate fund affects the UK's attractiveness as a location for these entities, and what the options might be for addressing such concerns.

3.21 The government has, for example, received proposals to expand the Real Estate Investment Trust (REIT) regime by broadening its availability to a wider class of UK property holding companies.

3.22 It has been argued that removing certain qualifying requirements, such as the requirement for shares to be listed on a recognised stock exchange, could better allow UK REITs to be used as intermediate entities within real-estate fund structures instead of those funds having to rely on overseas property unit trusts to ensure tax neutrality for exempt investors such as UK pension funds.

3.23 The government is therefore interested in how changes to the REIT regime might help support the objectives set out in this consultation, and how those changes might be effectively targeted at alternative fund holding structures.

Private Equity

3.24 The government understands that private equity funds often invest in target companies through one or more AHCs. It understands that these companies are generally located in countries with a strong treaty network, a broad exemption for share disposal on gains, and the absence of a withholding tax on outbound dividends.

3.25 Following the changes made to the SSE in 2016, including a change to ensure companies can benefit from the exemption for staggered disposals of substantial shareholdings, the UK fares well against these criteria. This has increased the UK's attractiveness for the location of AHCs within private equity fund structures.

3.26 Nonetheless, the government wants to understand whether there remain barriers to private equity AHCs being located in the UK and the extent to which similar barriers exist in other jurisdictions.

3.27 One specific issue that the government recognises is the difficulty in retaining the character of capital gains realised by a UK AHC on the disposal of shares in target companies when those investment returns are returned to the fund.

3.28 It is understood that this issue is in part a function of UK company law and the constraints this creates, compared to comparable law in other jurisdictions, on the mechanisms through which investment returns can be extracted from a company. The issue then comes down to the UK tax rules which treat the repurchase of share capital as an income distribution for UK participators in the fund including carried interest holders.

3.29 The government would like to better understand the extent to which profits on disposals effected through AHCs in other jurisdictions cause tax challenges for investors, and how it impacts on funds' decisions as to whether to locate AHCs in the UK. The government would also like to understand whether this is unique to AHCs within private equity funds, or whether it is also relevant to other asset classes in which gains are an important component of overall investment returns.

General challenges

Withholding tax on corporate interest

3.30 The UK imposes withholding tax on interest paid to non-residents, though has ceded its right to impose the tax in many of its double tax treaties. Several exemptions also exist, including the Quoted Eurobond Exemption (QEB) and private placement rules, which are each designed to support the efficient functioning of UK capital markets.

3.31 Despite the limited application of withholding tax on corporate interest, it has been suggested that the reliance on exemptions and the administrative burdens in meeting the requisite qualifying criteria represents a potential barrier for funds when evaluating whether the UK is a suitable location for AHCs.

3.32 The government is interested in views on the extent to which UK withholding provisions for corporate interest impact decision making when determining the location of an AHC.

Hybrid mismatch rules

3.33 The government remains committed to the hybrid mismatch rules following their application in 2017. These rules continue to form an important component of the government's defence against base erosion and multinational tax planning.

3.34 However, it has been suggested that the rules are having unintended and disproportionate impacts on the funds sector, reducing the attractiveness of the UK as a location for AHCs.

3.35 That includes the 'acting together' provisions and the application of the rules to deduction/non-inclusion outcomes that involve exempt investors. For instance, it has been suggested that a payment made to a fiscally transparent fund that has exempt investors, located in a jurisdiction that treat that fund as opaque, should not be automatically caught by the hybrids rules.

3.36 The government encourages stakeholders to provide evidence on any issues that hybrid mismatch rules create for AHCs within investment funds and how these issues might have been overcome in other countries' approaches to transposing the BEPS recommendations. Views as to whether the rules impose obligations that cannot be met, for instance, due to lack of information, will also be welcomed.

3.37 These issues will also be explored as part of an HMRC technical consultation, announced at Spring Budget 2020, which will be published in due course.

Chapter 4

Giving effect to change

Rationale

4.1 As set out in the previous chapter, industry has identified various and differing obstacles to locating AHCs in the UK. That reflects the challenges associated with applying general corporation tax principles appropriate to businesses organised in corporate form, to legal entities that serve a distinct function within fund structures, which is a challenge that has also arisen in other areas of the collective investment space. It also reflects differing considerations for the varying classes of alternative fund, and individual funds within each class, given the diverse range of their investment strategies and the consequent character of underlying investment returns.

4.2 If change is considered merited, one approach to address the identified obstacles would be to make a series of isolated changes to the various UK corporation tax provisions outlined in the previous chapter.

4.3 However, there could be challenges in making changes that are targeted at the issue and don't have unintended or undesirable consequences when applied across the general corporation tax paying population. There is also the risk that the changes fail to address an unidentified issue that only emerges as funds seek to establish AHCs in the UK.

4.4 Alongside isolated changes, the government is therefore also interested in exploring whether there may be a case for a more comprehensive approach to addressing the challenges to locating AHCs in the UK.

What might a more comprehensive approach look like?

4.5 Until such time that responses to the consultation have been reviewed, it is difficult to provide detail on what a more comprehensive approach might look like. However, one option might be the creation of a specific set of rules for companies that sit within certain defined investment fund structures.

4.6 The intention behind those specific rules would then be to ensure a tax outcome for AHCs in qualifying funds that is proportionate to their activities, thereby preventing a significant tax wedge between direct and indirect investment and ensuring the UK is an attractive place to locate these companies.

4.7 At the most basic level, these specific rules could lead to the disapplication of certain provisions within the corporate tax framework that have been identified as giving rise to disproportionate outcomes for AHCs. For example, companies that sit within defined investment structures might be subject to a broader SSE and or be subject to modified rules on interest withholding.

4.8 However, these specific rules could also involve an altogether different method for calculating the corporation tax liabilities of AHCs, or AHCs within certain fund classes. Such a regime could be formulated in a similar manner to the TSCR, which ensure qualifying companies receive the tax treatment that reflects their function within a securitisation transaction by affording them a different method of calculating their liability to corporation tax.

Considerations

4.9 Due consideration would need to be given to the entry criteria of any ring-fenced regime, including the definition of qualifying funds and the rules for determining which entities within a qualifying fund structure would be able to benefit from the bespoke treatment.

4.10 This would be essential in preventing abuse or avoidance while ensuring that only the intended targets of a new regime are able to access it. If the regime went beyond mere disapplication of certain general corporate tax provisions, and served a role more like the TSCR, consideration would be needed as to the appropriate tax outcome for qualifying AHCs and how that outcome is tailored to the nature of activities they undertake, which may differ on a case-by-case basis.

4.11 The government therefore welcomes views as to whether a ring-fenced regime for AHCs could suitably address the issues outlined in this consultation. Comments should consider the various fund vehicles used for investment strategies that respondents are familiar with.

Chapter 5
Questions

Question 1: What role do AHCs perform within alternative fund structures? What are the commercial and tax benefits of using AHCs within alternative fund structures, and 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 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 that they exist, currently overcome? How do the tax rules in other countries address these challenges?

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?

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?

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?

HM Treasury contacts

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If you require this information in an alternative format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

Email: public.enquiries@hmtreasury.gov.uk