Analysis

UK asset holding company consultation: the thick end of the wedge

Speed read

Not for the first time, the government has announced a review of the UK tax regime for funds. Part of this review looks at the asset holding companies in alternative fund structures, and whether there are UK tax rules which reduce the attractiveness of the UK as a jurisdiction in which to establish such companies. Set against the backdrop of Brexit and the OECD's BEPS project, the consultation is based on engagement with the asset management industry and looks to be very well targeted. There is a real opportunity for changes to be made to support the UK asset management industry, particularly in the context of credit funds, which have largely had to make do and mend by adapting existing regimes to their purposes. Readers are encouraged to engage with the consultation.

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Given the extraordinary chain of events since new chancellor Rishi Sunak stood up and delivered his first Budget not much more than two weeks ago, a development I regarded as quite exciting at the time is now easy to dismiss as trivial. However, in the coming months and years, as we advise asset managers on the challenges and opportunities presented by the economic fallout accompanying the Covid-19 pandemic, this may again be something that tax advisers, at least, can regard as significant.

As has become traditional at Budget time, the chancellor announced a review into the taxation of the UK funds. The review will be in two parts: VAT on fund management fees, with more detail to follow; and, the subject of this article, the attractiveness of the UK as a location for the intermediate entities through which alternative funds hold fund assets.

The issue is not a new one: fund managers are based in the UK but, with limited exceptions, the fund vehicles they manage and invest through are not. Previous attempts to address this conundrum have either tinkered round the edges or resulted in the introduction of niche new fund vehicles. Meanwhile Luxembourg and, to a lesser extent, Ireland, have motored ahead with a series of successful and commercially attractive vehicles.

The consultation focuses on alternative funds, which the OECD describes as non-CIV funds (basically private equity funds; see the simplified structure diagram from the consultation reproduced overleaf) and specifically on the companies (the 'asset holding companies') established by these funds to hold their investments – generally in the form of loans, real estate and shares. In spite of the size and economic significance of this sector, it often seems to get put in the 'too difficult' category in tax policy making. It is quite rare to see rules, other than anti-avoidance rules, aimed at this type of fund.

Backdrop to the consultation

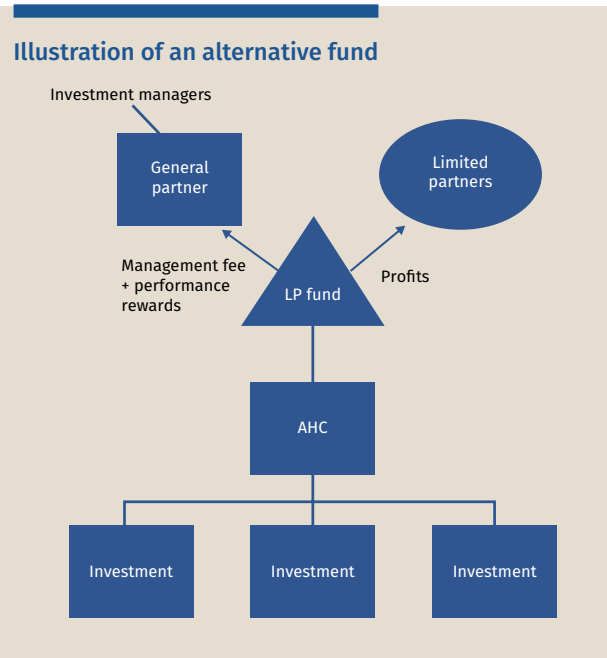
The consultation somehow avoids direct mention of Brexit, but it is a significant part of the backdrop, implicit in both the challenges ('there is a risk that funds shift existing UK management activities overseas to consolidate their presence in other jurisdictions', that presence often being required to allow funds to have comfort that they can continue to market to EU investors and offer a manager subject to continuing EU regulation in the form of the AIFMD) and the opportunities (a ring-fenced regime for UK asset holding companies, with no reference to state aid and other EU law challenges).

The other part of the backdrop that needs to be borne in mind is the OECD's BEPS project, and specifically the Treaty abuse workstream, which has resulted in many jurisdictions, including the UK, amending their double tax treaties to deny treaty benefits where an arrangement has a principal purpose of realising such benefits.

While the consultation accepts the commercial drivers for funds to operate through holding companies, it is not clear that this is accepted by all jurisdictions. It is generally agreed that in order to qualify for treaty benefits holding companies need 'substance', but there is little international consensus on what that means. In practice, many fund managers have sought to maximise their prospects of qualifying for treaty benefits by establishing their fund vehicle and a master holding company (used for all investments including where treaty benefits are irrelevant) in a single jurisdiction, often Luxembourg, and making sure that they have investment professionals there too to make the decisions required by the vehicles. This shift has happened over time and for many managers is quite advanced. Even if the UK can come up with a regime that compares to other jurisdictions, it may come too late to persuade these managers to change tack.

The consultation accepts as a starting point that a successful asset holding company regime cannot involve a significant layer of tax on through-bound investment flows as this would create a 'wedge' between direct and indirect investment. Given the limited additional tax in prospect, it quite reasonably starts off by asking what's in it for the UK. It feels like this question has already been convincingly answered through the points HMRC has already heard from engagement with industry, which has pointed out that a small percentage of a large amount is worth having; that indirect benefits will flow in the form of professional advice and resulting fees and employment income; and that without supporting action, there is a risk that the UK asset management industry leeches away over time.

Set against this, the government has established as a principle that it wants to be sure that changes do not just erode the existing UK tax base, and also that the changes fully adhere to international tax standards, as set by the OECD. The idea is to explore whether comparatively small changes could avoid the UK being ruled out where it seems the natural choice. It therefore seems unlikely we will end up with a regime to rival Abu Dhabi's global market.



Private equity

It is relatively common to see UK asset holding companies in the private equity context, albeit mainly for UK deals and rarely as master holding companies. The group relief rules make this an efficient structure for effectively pushing acquisition debt down into a UK target. In fact, you will occasionally see a UK company in a chain of otherwise non-UK holding companies for a similar reason.

The challenge for the UK that the consultation identifies here is fairly subtle. Due to the UK's distribution rules, it is difficult for UK companies to return profits to shareholders in a form which attracts capital treatment (at preferential rates for UK individuals) except in a total liquidation. Thanks to *Rae (Inspector of Taxes) v Lazard Investment Co Ltd* (1963) 41 TC 1, the same difficulty does not arise on the return of profits by non-UK companies, assisted by helpful corporate mechanics such as the partial liquidation of 'alphabet shares'.

One might not think that the position of UK individuals would impact fund structuring until you consider that the affected individuals are likely to be carry holders and often the ones making the structuring decisions (or their bosses). Additionally, and not mentioned by the consultation, it has traditionally been preferable for UK non-doms to invest directly into non-UK companies. While this is generally no longer relevant for carryholders, it could still be relevant for some other investors.

The consultation talks about capital gains retaining their character, but it is one of the interesting features of a holding company or a chain of holding companies that what goes in the bottom is not necessarily the same as what comes out of the top. Will it be enough for the UK to provide an exemption from the distribution rules where a return of capital can be traced to an underlying capital gain, where another jurisdiction may offer the same treatment even where the underlying receipt is a dividend?

UK asset holding companies may also be attractive to non-UK private equity managers structuring non-UK deals, who may not be exposed to the issue mentioned above, or not to the same extent. In my experience, however, there can be some concern in the international context as to whether the UK is genuinely committed to a stable low-tax holding company regime. To some extent this is historic, possibly prompted by past experience where clients have considered the UK, only to find that they are going to run into difficulties with the SSE expiring mid-way through a staged exit on an IPO, or not applying at all because the target business is in a joint venture. Even if this consultation doesn't produce any other benefits, a clear statement that the UK is committed to the existing regime will be very welcome.

The consultation does not specifically talk about shareholder debt, but this is another challenge for the UK as an asset holding company for private equity. The issues are generally similar to those discussed below in the context of credit funds. With BEPS inspiring many jurisdictions to introduce or tighten corporate interest restriction rules, tax deductibility is often not available, so shareholder debt is now less common than it has been historically. However, some managers still find debt attractive for reasons including the ease of repatriation of funds, particularly where AIFMD asset stripping rules may apply, and the preferential ranking of lenders in an insolvency. In that context, UK withholding tax on interest, and the unavailability of a corresponding adjustment for deductions which are denied under corporate interest restriction rules, may lead them to consider a non-UK alternative.

Credit funds

In the shadow of the last financial crisis I was involved in an initiative concerning alternative credit providers which would emerge to challenge the banks as corporate lenders. We weren't quite clear where the money would come from or how the lenders would be structured. However, we did identify that there were some tax rules aimed specifically at banks, such as the ability to sub-participate without tripping up on the distribution rules, the absence of which could make life difficult for these challengers.

When I got a close look at a proper credit fund, I found a strange amalgamation of a private equity fund and a securitisation. There were a lot of questions.

Could they originate loans? If they were carrying on the same lending activities as a bank, what about trading and permanent establishment issues? Can you be totally comfortable that they are not a conduit for withholding tax purposes? VAT on servicing? Who gets origination fees? Does this transfer pricing study really make sense?

It got worse for a time with the introduction of the hybrid rules, as there was a genuine concern that third party borrowers from debt funds would have their interest deductions denied under the imported mismatch rules.

In addition, working with credit funds is always an education in obscure withholding tax rules: can a partnership consisting of UK corporates and treaty qualified non-UK corporates really not claim exemption? Moving away from the UK, do any of the entities qualify as sufficiently regulated to qualify for exemption from Italian withholding tax?

Given their economic significance, tax authorities generally seem to have accepted the solutions to these various issues adopted by credit funds, but it continues to be an evolving picture, with the tax-exempt Luxembourg RAIF recently gaining popularity thanks to some quirks in

the new Luxembourg hybrid rules.

The basic requirements for a credit fund asset holding company include a wide treaty network, tax on a small margin, the ability to on-pay without withholding tax, and a flexible regulatory framework.

One of the UK's major challenges from a tax perspective is the distribution rules which prevent interest deductions for profit participating and limited recourse debt. If the lender can't limit risk in this way, the spread it can be expected to make for transfer pricing purposes increases so as to become uncommercial.

The UK securitisation company looked like it provided some good answers to addressing some of these issues by effectively taxing on the basis of a cash margin. Unfortunately, unlike the comparable regimes in Ireland and Luxembourg, HMRC has interpreted the rules in a way which is too narrow for the purposes of credit funds, effectively limiting their use to traditional securitisations. The consultation makes a good point in this context noting 'the vital importance of regime stability for users of existing securitisation companies'. The UK securitisation vehicle is a market leading vehicle for traditional securitisations, and it would be a real own goal to do anything to upset this.

A special regime specifically for credit funds would be a first and could prove very attractive

As far as I'm aware, a special regime specifically for credit funds would be a first and could prove very attractive. It is possible to imagine a regime based on the securitisation company regime but with an increased range of eligible assets, and perhaps an increased taxable margin. To counter the prospect of abuse, the availability of the regime could be limited to funds passing a genuine diversity of ownership test (ideally reformulated to resolve some of the glitches experienced with that test in the context of the new real estate rules discussed below), and a substance requirement could also be considered – that may also encourage borrower jurisdictions to view it favourably from a treaty abuse perspective. An exemption from withholding tax for payments made by the vehicle to the fund would be welcome, as would protection from at least the worst uncertainties of the hybrid rules, some of which are the subject of a separate consultation also announced with the Budget.

Real estate funds

The structuring of real estate funds with a UK focus is still in flux following the recent introduction of non-resident capital gains tax, and the move from income tax to corporation tax for non-UK companies holding UK real estate. A tension has been created between different classes of investor ranging from exempt investors who would like a pass through structure so that they can benefit from their exemption, taxable investors who may also like a pass-through structure so that they can claim credit for UK taxes in their home jurisdiction, and other investors for whom avoiding a direct UK filing and payment obligation is the paramount consideration.

These issues can be dealt with to some extent by complex upper tier structuring grouping investors into an appropriate sleeve, but that is considerably more difficult for funds for whom UK real estate is only part of their strategy.

While UK real estate has traditionally been held by non-UK companies, particularly Jersey and Luxembourg, these companies now face an inside basis issue. It remains the norm in UK commercial real estate transactions to sell the property holding vehicle rather than the property, with the stamp duty land tax cost being a significant consideration. Under the new UK rules, the sale of the company is typically subject to UK capital gains tax (currently some protection can still be afforded by the UK Luxembourg double tax treaty but this is subject to anti-avoidance rules and it is thought likely that the treaty will be renegotiated to remove this benefit). However, there is no step-up in the base cost which the company has in the underlying property, meaning that a purchaser will be concerned that if it ever has to sell the underlying property it would be subject to tax on the historic gain.

This issue looks set to increase even further the popularity of Jersey and Guernsey property unit trusts, which can elect to be treated as transparent for capital gains tax purposes. This removes the inside basis issue, while still providing a vehicle which can be sold without a UK stamp duty cost. Given that the purpose of the changes, to the extent one can be discerned, seems to be to put non-UK vehicles on a level playing field with UK vehicles, this motivation to use a non-UK asset holding company seems anomalous.

If this consultation can have a result which moves beyond tinkering with existing rules and produces a user-friendly, commercially attractive and government supported regime, that will be a real achievement and a material boost for the UK asset management industry

The consultation floats the possibility of adapting the UK REIT rules so that REITs could be used as an alternative to JPUTs and GPUTs. In very big picture terms, a REIT is exempt on income and gains which are instead taxed when the profits are passed through to investors. Currently, REITs are usually big operations such as British Land which are listed and designed to give a range of institutional and other investors exposure to UK real estate as a class (as opposed to individual buildings). It is therefore a pretty big shift to have the same vehicle in the position commonly used by JPUTs and GPUTs in existing fund investments. However, an onshore vehicle with the same attributes as JPUTs and GPUTs – transparent for income and gains with no stamp duties on transfer – can be expected to be popular.

One feature of REITs which could be very attractive is that they generally impose tax on investors through withholding. Fund managers are very keen, and often required through side letter commitments, not to expose investors to tax filings, even where, as noted above, that might help investors to credit such taxes against their local liabilities. If tax was imposed by means of withholding rather than directly, it seems likely that this would offer a more attractive path to avoiding double taxation.

It is also notable that the withholding tax imposed by REITs can be reduced under double tax treaties. In other jurisdictions, such as Spain, it has been possible for treaty

qualified investors to use similar vehicles to reduce the effective level of tax paid locally on a disposal of the underlying real estate. It is not clear whether HMRC is anticipating the effect of treaty relief in this context, but it does acknowledge that the REIT could be used to ensure tax neutrality for exempt investors such as UK pension funds, by which I would understand complete exemption. A relaxation of the REIT rules, for example to allow single asset REITs in fund structures, is therefore a very interesting proposition.

The other issue mentioned in the real estate context is that the UK substantial shareholding exemption (SSE) does not typically apply where the company being disposed of is a real estate investment company (the exception being where the investor is more than 80% owned by qualifying institutional investors (QIIs)). This makes them an unattractive ultimate holding company for real estate investment because it would be necessary to consider capital gains tax at the UK level as well as in the underlying jurisdiction.

Other jurisdictions do not generally have an equivalent in their participation exemptions to the trading condition found in the SSE. The consultation asks for a response both to expanding the QII rules, presumably by including alternative funds as QIIs. Given HMRC's continued concerns with 'the tax-motivated enveloping of a business's productive assets', it is difficult to see this second option gaining traction. The consultation also notes that it will not offer a side door to tax-free UK real estate investments; disposals of UK property rich companies would be carved out of any expanded SSE.

Giving effect to change

The final chapter of the consultation sounds out the possibility of a new bespoke regime for UK asset holding companies, possibly operating in a similar manner to the securitisation company regime. I expect this would be attractive for fund managers for the reasons discussed above in the context of credit funds. However, given the different considerations across the different asset classes as discussed above, my view is that a single regime might not be sufficiently targeted to be attractive in all circumstances.

However, I do think there is an excellent opportunity to provide a bespoke vehicle for credit funds and also to look and see if the UK can find an onshore solution to situations where the existing rules point towards an offshore solution which does not otherwise have a strong commercial driver, such as a captive JPUT, or an offshore listing of debt within a fund structure.

This article only begins to touch on the issues raised by the consultation, and I expect readers will have a range of views and issues, many of which I hope will find their way into consultation responses. If this consultation can have a result which moves beyond tinkering with existing rules and produces a user-friendly, commercially attractive and government supported regime, that will be a real achievement and a material boost for the UK asset management industry. ■

The condoc is available at bit.ly/2QSqAMH. The consultation closes on 19 May 2020.

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- Budget 2020: report of tax measures (12.3.20)
- Tax issues on private equity transactions (Brenda Coleman, Andrew Howard & Leo Arnaboldi III, 7.11.18)