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BVCA Policy & Technical Guide

The Qualifying Asset Holding Company Regime

August 2023

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1 Introduction

The UK's Qualifying Asset Holding Company (QAHC) regime has been in place since April 2022. It was developed as part of the UK government's wider review of the funds regime, which was launched in 2020 and encompassed both tax and regulation. The QAHC regime was intended both as a response to the holding company regimes offered by other European fund centres, and to bolster the UK's "offer" as a destination in which funds can co-locate multiple functions.

Broadly speaking, in the context of a typical fund structure, a holding company is a corporate vehicle, generally established between the pooled investor vehicle, such as a fund limited partnership, and the underlying investee asset(s) in the portfolio. Many funds establish a single "master" holding company for multiple investments, but the term "holding company" is also applied to a single investment company or to companies in the acquisition "stack", which is formed for the purposes of an acquisition or raising acquisition finance. Holding companies have a number of benefits, including simplifying the management of underlying entities, streamlining treaty applications (subject to eligibility criteria) and easing entry into deal documentation.

The UK tax system prior to the introduction of the QAHC rules included elements that made it potentially attractive as a holding company location, including the absence of withholding tax on dividends and a large double tax treaty network. There were, however, a number of barriers, including the complexities involved with obtaining exemptions from withholding tax on interest, and uncertainties around the availability of the substantial shareholding exemption.

The result was that despite the English limited partnership (generally formed as a Private Fund Limited Partnership) being an excellent fund vehicle option, many funds, including those managed by UK management teams, opted to locate their holding structures outside the UK where the regimes were more established and attractive. The QAHC was designed, against this background, as a tax neutral holding company that does not expose investors to an additional layer of tax compared with investing directly in the underlying assets.

In recent years, in order for a holding company to benefit from a number of relevant tax reliefs (treaty, EU Directive or domestic), it has had to fulfil a greater number of eligibility tests. This has resulted in an increased focus on what is generically referred to as the "substance" of the holding company, including the potential need to demonstrate that the company was not set up in that jurisdiction purely to benefit from the applicable tax relief. This is an easier challenge to meet if the management team and the holding company are in the same jurisdiction, since the natural choice for a holding company jurisdiction would seem to be that of the management team. This gave added impetus to the development of a coordinated regime that would be attractive to the UK asset management industry and be a competitive alternative to existing non-UK regimes.

The BVCA was an active participant in all stages of the consultation that resulted in the original QAHC legislation and its accompanying guidance, and continued this engagement in the improvements to both legislation and guidance that were made in 2023.

This Guide is produced by the BVCA for the benefit of its members and reflects the law as of August 2023. It does not constitute legal advice. BVCA members should obtain legal advice that is specific to their own circumstances before deciding on any particular course of action.

2 Overview – eligibility

Unlike the holding regimes in some other jurisdictions, the advantages of the QAHC regime are dependent upon meeting certain requirements. The key requirements for a company to become a QAHC are as follows.

- The company must be UK tax resident.
- The company must meet the ownership condition discussed in more detail in the context of funds as eligible owners at Key issue – qualifying funds and diversity of ownership, below.
- The company must be unlisted - no equity securities of the company may be listed or traded (on a recognised stock exchange, or other public market or exchange).
- The company must meet the activity condition.
- The company must meet the investment strategy condition.
- The company must be neither a securitisation company nor a REIT.
- The company must elect into the regime with a QAHC resolution.

These requirements are discussed in more detail below.

Residence

A QAHC must be UK resident, but there is no requirement that it be incorporated in the UK. Companies may be UK resident for tax purposes if incorporated outside the UK but with their "central management and control" in the UK. The legislation itself envisages the possibility of non-UK incorporated companies using the regime and this may bring with it certain benefits for some funds and for their management teams e.g. in the context of the remittance basis (discussed further at Overview – consequences, below. It may also enable the company to access a more beneficial corporate law regime to make it easier to undertake share buybacks if distributable reserves might otherwise be an issue.

Ownership

In general terms, ownership is likely to be the most challenging consideration for those seeking to use the QAHC regime since, although it is anticipated that most funds establishing a wholly owned QAHC will meet the ownership test, the area is not without its shortcomings and more complicated or unusual ownership arrangements will require bespoke analysis. The key requirement is that the sum of "relevant interests" held in a QAHC by those who are not "Category A investors" must not exceed 30%. This is sometimes referred to as a 70% test for "good investors", but it is more correctly viewed as quite a constraining cap on other investors.

Only the types of investor listed below can be "Category A investors".

- A QAHC.
- A qualifying fund – this is likely to be the most important category and funds must meet certain requirements including a diversity of ownership condition. The importance of this area means it is separately addressed at Key issue – qualifying funds and diversity of ownership, below.
- A relevant qualifying investor.
- An intermediate company – this is a company 99% owned by other Category A investors other than QAHCs.
- A public authority falling within stated categories – this is confined to UK public authorities.

2 Overview – eligibility

The heading of "relevant qualifying investors" is intended to include certain types of investors commonly viewed as institutional. These are set out below.

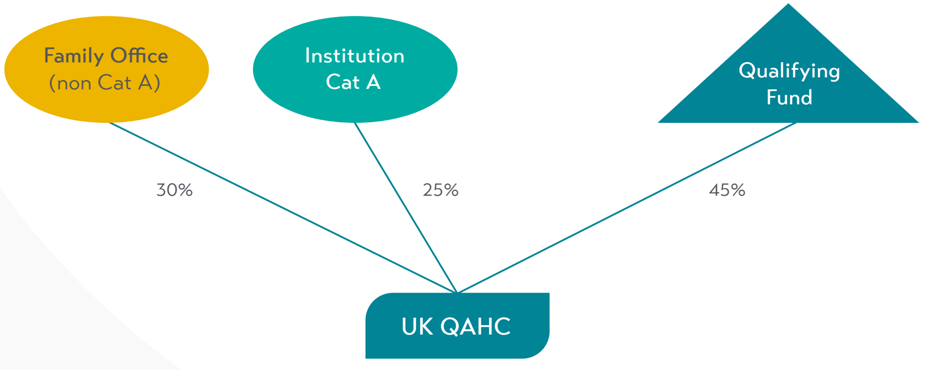
- A person acting in the course of a long-term insurance business who is authorised under FSMA 2000 or has equivalent authorisation under an overseas law.
- A person who cannot be liable for corporation tax or income tax (as relevant) on the ground of sovereign immunity.
- A UK REIT or overseas equivalent.
- Certain overseas property investment entities.
- A trustee or manager of a pension scheme.
- A charity, unless closely associated with persons involved in management of the company.

The intention of the relevant qualifying investor category (especially when combined with the intermediate company category) is to permit such investors to establish their own QAHCs or to invest alongside a fund into a QAHC without a negative impact on the ownership requirement.

In considering whether the 30% limit is breached, the QAHC rules prescribe computational provisions to assess the true proportion of the "relevant interest", including where such interests are held via another QAHC. There are multiple rules designed to prevent manipulation where in substance the non-Category A investors hold a larger proportion. These include anti-fragmentation rules to prevent non-Category A investors splitting their holdings or holding part of their participations via a qualifying fund (the latter being generally "opaque" in considering the proportionate Category A investor holdings).

The test of "relevant interest" draws on standard UK corporation tax tests of grouping, looking at both economic and voting percentages – although not nominal values – with the addition of certain further elements to cater for asset linked shares, and shareholdings and other participations giving a carried interest type of return that changes over the life of the investment. Generally, the rules take the maximum of any measure over the life of the entity in assessing contribution to the 30% limit. The percentage interests of loan creditors are generally excluded from the calculation.

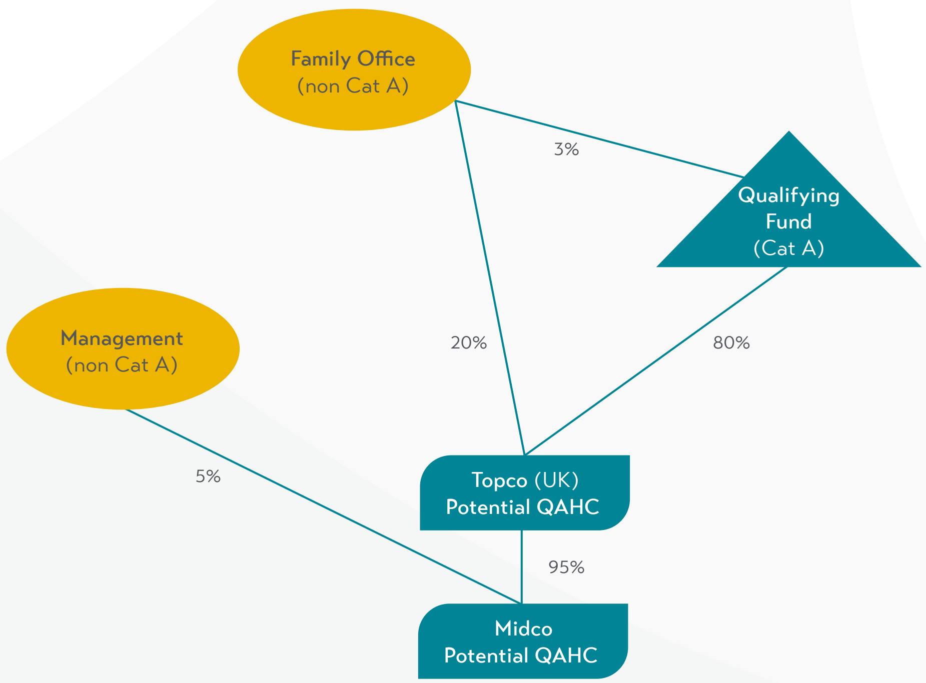
Below is a relatively simple example of a qualifying fact pattern.



On page 6 is a slightly more complicated ownership example. In this case, at first glance, it would seem that "Topco" should be a QAHC and, since it owns 95% of "Midco", that Midco should qualify as a QAHC itself. However, the actual ownership by the "Family Office", the non-Category A investor, needs to be more carefully considered given the anti-abuse provisions. Since the Family Office holds both a direct interest in Topco and an interest in the Qualifying Fund, a calculation must be performed as set out below to determine the actual relevant interest of the Family Office.

2 Overview – eligibility

3% via the fund	3% x 80% x 95%	2.28%
20% direct	20% x 95%	19%
		21.28%



Midco should, in this case, still qualify since, even with the additional 5% of non-Category A investors in the form of the management team, the overall non-Category A holding should still be only 26.28%. However, this example starts to demonstrate some of the complexities involved in potential structures.
These are of especial concern where the fund executive team, like the Family Office above, invests partly directly and partly via the fund, especially when carried interest is involved. Specific advice should always be sought in such cases.

Qualifying funds and diversity of ownership condition

The category of qualifying fund is likely to be of greatest interest to the investment fund industry. A qualifying fund must be a collective investment scheme (CIS) or alternative investment fund (AIF) and must meet a diversity of ownership condition. Since this issue is considered key to BVCA members, it is separately considered in detail in Key issue – qualifying funds and diversity of ownership, below.
As an overview, the diversity of ownership condition can essentially be met in one of the ways set out below.

- A CIS, or an AIF that is not a CIS only because it is a body corporate, that meets the marketing and other conditions in the Offshore Funds (Tax) Regulations 2009, referred to as the "Genuine Diversity of Ownership" (GDO) requirements – "multi-vehicle arrangements" (including parallel and aggregator funds) can pass the GDO test by reference to the arrangements as a whole, even if a particular investment vehicle in isolation would not meet the GDO requirements
- A non-close fund
- A fund which is 70% controlled by Category A investors

2 Overview – eligibility

Activity

A QAHC must meet the activity condition. This requires that the main activity of the company is the carrying on of an investment business, and that any other activities of the company are ancillary to that business and are not carried on to any substantial extent.

Technically, this condition is unlikely to pose a major difficulty for most private equity, credit and other private capital strategies. The HMRC guidance makes clear that the intention is to ensure that management services provided to investee companies should not be a material impediment to fulfilment of the activity test. Specific possible concerns on credit funds are addressed in Specific funds – credit funds below but, as is stated in that section, the HMRC guidance is helpful in making it clear that HMRC accept that the activity of a credit fund may be investment and not trading.

Investment strategy

This condition requires that the investment strategy of the potential QAHC does not involve the acquisition of equity securities listed or traded on a recognised stock exchange or any other public market or exchange, or other interests that derive their value from such securities. It should be noted that acquiring listed debt is not prohibited under the investment strategy condition.

This is subject to the proviso that the strategy could involve the acquisition of listed equities for the purpose of facilitating a change in control of the issuer of those securities with the result that its securities are no longer listed or traded. This proviso should permit public to private transactions, or stake-building prior to a takeover bid. Should the bid not complete, the guidance suggests the bidder would generally be expected to divest of the stake that had been built, although this is not a legislative requirement.

The investment strategy condition is derived from the concern that dividend income could be rolled up tax free at the level of the QAHC and extracted as gain to investors. This is specifically stated as being the concern in the guidance. However, the wording of the condition itself is unfortunately proscriptive since, it does seem to indicate that a strategy which envisages the possible acquisition and holding of even a minimal number of listed equities could result in QAHC status being denied. Unlike the activity condition, there is no scope for listed shares to be an ancillary strategy.

HMRC's guidance provides some comfort that it would not take an extreme interpretation of this provision. It states that a company will only have an investment strategy of acquiring listed shares when it is actively pursuing such a strategy. It will not fail the condition merely because it is not precluded from making such investments and might consider such a strategy in the future.

It is possible for a QAHC to make an election to treat the investment strategy as having been met, but the price of this is to switch off the tax exemption for dividends in respect of listed equities. The switch-off applies to all listed securities held by the QAHC, even those that may have been acquired as part of a public-to-private transaction. The election is irrevocable for so long as the company remains a QAHC.

Joining and leaving the QAHC regime

As stated, a QAHC must make a formal election to join the regime and must notify HMRC of this in a process set out in the guidance.[1] Upon making such election, a new accounting period is deemed to start, which will have various UK corporation tax consequences, including the rebasing of assets.

A company can join the QAHC regime for a two-year grace period without immediately meeting the ownership condition. Similarly, if a company joins the regime meeting the ownership condition but ceases to meet it within the first two years then a similar grace period is allowed running from entry into the regime. During the grace period there must be a reasonable expectation that the ownership condition will be met by the date two years from entry into the regime. In addition, HMRC must be notified if the grace period is to be relied upon, whether due to not meeting the ownership condition immediately or due to a breach of the condition in the first two years. The grace period does not allow for entry into the regime to be "backdated" – operation as a QAHC may not be earlier than the day after the date of notification to HMRC.

While the default position is that a breach of condition results in the loss of QAHC status from the date of breach, the rules contain provisions to prevent "cliff edge" loss of QAHC benefits in circumstances in which the breach may well be inadvertent or temporary. It is unlikely that a company would suddenly and unexpectedly list or become non-UK resident, but there are provisions relating to the activity condition and the ownership condition where inadvertent or temporary breaches may be more likely. However, it is still key that, once in the regime, compliance must be carefully monitored, as the mitigating provisions for breach generally require awareness of the position and communication to HMRC. There are various cure period rules; for example, once there is awareness of a breach of the ownership requirements there are then 90 days to rectify the matter, as long as the breach does not result in 50% non-Category A investors.

On exit of a QAHC from the regime, a new accounting period is, as with entry, deemed to start and certain assets are deemed to be sold and re-acquired. Commonly, the consequences would be sheltered from tax, either as a result of the QAHC share disposal exemption or the substantial shareholding exemption, but this is not always the case, e.g. there could be charges in respect of loan relationship balances.

There is a "ring-fence" concept applicable to the QAHC, such that certain categories of assets held otherwise than for the purposes of investment activity can be segregated from investment assets. The company would then be eligible for the benefits of the QAHC regime only in relation to the investment activity. Use of the "ring-fence" concept brings with it certain complications, especially in relation to tax losses and the transfer of assets out of the ring-fence. There are also issues in relation to transfers within a group of companies where the ring-fence is crossed. Bespoke advice should always be sought in relation to use of the ring-fence.

[1] A Unique Taxpayer Reference ("UTR") is not required for the notification but will be required for the information return described below and for UK tax returns.

3 Overview – consequences

This section summarises the tax benefits of joining the QAHC regime.

Background

The QAHC regime amends a number of UK tax laws in order to provide a tax neutral holding company vehicle with the aim of ensuring that it does not expose investors to a tax liability greater than had they invested directly in the underlying assets. That aim is largely achieved as described below.

Full exemption from tax on sale of investee company shares

A QAHC will not be subject to corporation tax on the gains arising from the sale of shares when it disposes of its portfolio companies. This a very straightforward relief without any conditions and is therefore a significant improvement on the complex substantial shareholding exemption. The QAHC exemption does not extend, however, to the sale of property rich companies, i.e. those which derive at least 75% of their value from UK real estate. This is to be expected as the QAHC regime is not intended to apply to UK real estate holdings.

Unlike the regimes in some other jurisdictions, there is a no minimum participation for the gains exemption. This is an advantage of the QAHC regime in instances where the relevant participation requirements are likely to be an issue.

Not subject to UK withholding tax

Payments of interest by a QAHC will not be subject to the usual 20% UK withholding tax. This is, again, a very straightforward relief without any conditions attached as to the nature or status of the debt instrument on which the interest accrues or as respects the identity or status of the lender. It also removes the administrative burden and cost that might otherwise be incurred in listing the debt instrument on a recognised stock exchange so as to fall within the established Eurobond exemption from withholding tax.

Since the UK does not levy a withholding tax on the payment of dividends, the QAHC regime therefore presents a holding company structure which is not at risk of exposure to withholding tax costs on interest or dividend payments. Unlike many other jurisdictions, it is not necessary to rely on a domestic or treaty exemption in order to remove or reduce a withholding tax liability.

Low corporation tax profile

A QAHC is not exempt from tax. It will pay corporation tax on its income profits but only to the extent proportionate to its activities. It is anticipated that this level of profit will be relatively low because its activities as a holding company will be relatively minimal. The appropriate level of profit will be subject to the usual transfer pricing rules.

This profit will also likely benefit from a lower corporate tax profile than usual, because the corporation tax rules have been specifically amended to accommodate QAHCs. Certain aspects of the distribution rules do not apply, so that QAHCs may take a deduction for interest costs on profit participating loans. Certain elements of the hybrid mismatch rules also do not apply to QAHCs. Similarly, the late paid interest rules do not apply, so that QAHCs may take any available deduction for interest on an accruing basis rather than on a paid basis.

It should be borne in mind that a QAHC is in the first instance a normal UK taxpaying company and will be subject to tax as such save to the extent the QAHC regime amends the position. Therefore, the corporate interest restriction, among other rules, will apply to QAHCs in the same way as they apply to companies which have not elected into the QAHC regime.

The corporation tax profile of the QAHC should not, generally, result in any issues with treaty eligibility. As stated above, it is a taxpaying company. The exemption from gains may mean that, if a gains article in a specific treaty were to require that the gains be taxable in the UK, relief would be denied, but such provision is extremely unusual. It should not be the case that the more general eligibility requirements of being "subject to tax" or "liable to tax" can be invoked against a QAHC. That said, it is up to countries from which relief is sought to grant it and, since the QAHC is a new type of entity, the possibility of a specific country raising this issue cannot be precluded.

Return of value in a capital form

Perhaps a key feature of the QAHC regime is that it enables QAHCs to return value to investors in a capital form by way of a share buyback. Ordinarily a share buyback creates two types of return for a shareholder who is a UK taxpayer. The repayment of the amount subscribed for the share is treated as a capital receipt and, where that is equal to the taxpayer's base cost, no tax arises. The payment of premium, i.e. any amount in excess of the subscription price, is treated as an income distribution and taxed accordingly.

The full amount paid by a QAHC to a shareholder on a share buyback will be treated as capital and taxed within the capital gains tax regime. The capital gain will not be at risk of being recharacterised as a dividend by the transactions in securities rules. That is because this anti-avoidance regime is specifically disapplied for QAHC share buybacks.

This advantageous tax position is currently diminished to some extent because UK corporate law has not been amended. A QAHC incorporated in the UK will continue to require distributable reserves in order to undertake the share buyback. Distributable reserves are often in short supply in leveraged structures, although consideration should be given to whether a reduction of capital may generate sufficient distributable reserves in any particular case.

One might therefore consider whether to incorporate a company outside of the UK, in a jurisdiction which has more flexible corporate law in this regard. Provided that company is tax resident in the UK and meets the QAHC regime's qualifying conditions outlined above, it will not be prohibited from electing into the regime. There is an element of irony that a regime designed to encourage co-location of a fund and its manager in the UK may encourage the incorporation of companies outside the UK. Additionally, this option may represent certain challenges in the area of e.g. treaty relief and clarity on residence. It is to be hoped that this issue will be resolved in due course so that distributable reserves will not present an issue.

It is important to note that the position for the management teams holding shares in a QAHC is unchanged in that they neither benefit from the capital treatment referred to above nor are the transactions in securities rules disapplied. This could be seen to be as expected as there is no policy driver to the QAHC regime which would suggest management teams holding shares in a QAHC should be advantaged compared to those teams' holding shares in a company that has not (or cannot) elect into the regime.

The remittance basis

The UK remittance basis of taxation provides that individuals who are UK tax resident but are not domiciled in the UK are not taxed on their foreign gains and income unless these are remitted to the UK. Broadly speaking, a return from a UK resident company would, for these purposes, generally be taken to be UK source rather than foreign source and would therefore be taxed as it arose.

3 Overview – consequences

This rule could act as quite a significant disincentive to UK tax resident non-domiciled fund managers in adopting QAHCs into the fund structures they manage. However, the QAHC regime amends this rule for these fund managers by, in effect, dividing returns from QAHCs into those derived from the UK assets of the QAHC and those from the non-UK assets of the QAHC.

The returns derived from the UK assets of the QAHC will be treated as UK source and taxed in the UK as they arise. The returns derived from the non-UK assets of the QAHC will be treated as foreign source and will only be taxed in the UK if those returns are in fact remitted to the UK. It may therefore be possible for UK tax resident non-domiciled fund managers using the remittance basis to arrange their affairs such that they are not taxed on gains and income derived from non-UK assets of a QAHC.

It is important to note that the UK carried interest rules already operate so as to limit use of the remittance basis on carried interest gains where non-domiciled individuals essentially perform their investment management services in the UK. Thus, the changes described above are largely relevant to co-investment only. In addition, the modifications only apply to the investment management team. This means that high net worth individual investors, friends and family investors etc. do not benefit. This is unfortunate since it clearly means that a QAHC will be less attractive to these investors and, in the event a QAHC is used, it creates a lack of alignment between the interests of the fund management team and their investors where both include remittance basis users.

Furthermore, even though the remittance basis modifications are helpful in ensuring that underlying non-UK assets do not automatically give rise to UK tax, use of a non-UK holding company instead of a QAHC could still result in more beneficial and less complicated tax treatment for remittance basis users by maximising the scope for foreign source income or gains. In addition, the rules do not address the position of investors (including fund managers) who may seek to use unremitted funds to invest into a structure which includes a QAHC. What actually constitutes a remittance can be complicated and fact specific but the use of a QAHC will likely increase the risk of such investment being, in itself, a remittance with the related tax consequences.

Accordingly, it may be that alternative regimes are considered in instances where there are a number of remittance basis users involved in the overall structure.

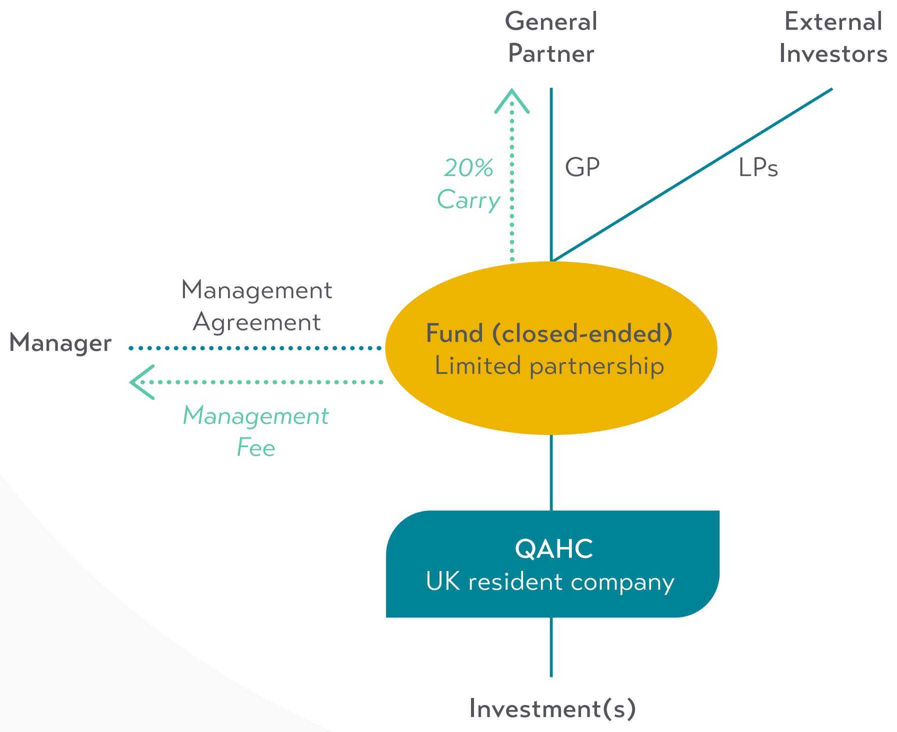
4 Key issue – qualifying funds and diversity of ownership

In this section, more detail is given on a key issue for funds, namely that of ensuring that they are able to be a "qualifying fund" and thus treated as a Category A investor of a holding company, so that the holding company is eligible to be a QAHC. The complexity of this issue makes it appropriate for it to be considered in more depth, however this should not be a substitute for specific advice on the issue, which should always be separately sought.

Introduction

The ownership condition in the QAHC rules is likely to be the most important part of the legislation from the perspective of a sponsor whose holding company will be wholly owned by a closed-ended fund that is established as a limited partnership or similar vehicle. This is likely to be the "base case" QAHC structure for many BVCA members and it will require the fund in question to be a "qualifying fund" and thus a Category A investor so as to render the holding company eligible for the QAHC regime. As stated above, qualifying funds must be AIFs or CISs which meet a diversity of ownership condition.

"Base case" fund structure



4 Key issue – qualifying funds and diversity of ownership

To briefly recap: in order to be eligible for treatment as a QAHC, a company must meet, among other conditions, an ownership condition that at least 70% of its relevant interests are held by Category A investors (which include qualifying funds). A sponsor with our "base case" will need to determine whether the Fund is a qualifying fund, meaning that the Fund satisfies the following criteria:

1. It is a CIS or an AIF; and
2. It meets at least one of the tests for diversity of ownership, namely that it is:
    a. A CIS, or an AIF that is not a CIS only because it is a body corporate, that meets marketing conditions based on those in the Offshore Funds (Tax) Regulations 2009 (the genuine diversity of ownership or GDO requirements) – there are provisions, considered in more detail below, which (with effect from 11 July 2023) enable "multi-vehicle arrangements" (including parallel and aggregator funds) to pass the GDO test by reference to the arrangements as a whole, even if a particular investment vehicle in isolation would not meet the GDO requirements;
    b. A non-close fund; or
    c. A fund which is 70% controlled by Category A investors.

Each of these criteria and tests is addressed in turn below with key issues that arise in their application to certain common fund structures highlighted.

Is the fund a CIS or an AIF?

"Collective investment scheme" or CIS and "alternative investment fund" or AIF are UK regulatory terms that bear similar core definitions. Most funds raised by BVCA members, other than a fund of one, should meet at least one of these definitions, although this is a technical, regulatory point which should always be confirmed.

CIS and AIF core definitions

"Collective investment scheme" or ***CIS:***

"any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income"

A ***CIS*** must, additionally, be such that:

- the persons who are to participate do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions;
- the contributions of the participants and the profits or income out of which payments are to be made to them are pooled; and
- the property is managed as a whole by or on behalf of the operator of the scheme.

Exclusions:

- A "body corporate" (other than an open-ended investment company)
- See the Schedule to the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001 for other exclusions

Source: section 235 of the Financial Services and Markets Act 2000

"Alternative investment fund" or ***AIF***:

"a collective investment undertaking … which: (a) raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of these investors; and (b) does not require authorisation pursuant to Article 5 of the UCITS directive"

Exclusions:

- Pension funds
- Holding companies
- Certain employee incentive schemes
- Securitisation SPVs

Source: regulation 3 of the Alternative Investment Fund Managers Regulations 2013

4 Key issue – qualifying funds and diversity of ownership

Each of these terms is subject to various, and not entirely similar, exclusions. As discussed above BVCA members should note, in particular, that a closed-ended fund that is a body corporate is treated as not amounting to a CIS (whereas there is no equivalent exclusion in the AIF definition).

A fund may use the GDO test either if it is a CIS, or if it is an AIF which is not a CIS only because it is a body corporate. This was not the case when the QAHC rules were first enacted, as originally only a CIS could use the GDO test. The change was made by the Finance (No 2) Act 2023, and took retrospective effect from the date the QAHC regime came into force. The amended rule means that the GDO test can be used by a number of types of entity that were previously unable to use this route, including Delaware limited partnerships.

Diversity of ownership tests

Genuine diversity of ownership (or GDO)

Many funds raised by sponsors that are BVCA members are likely to be able to meet the GDO test, perhaps following minor modifications to their current offering documents. It thus represents a relatively straightforward and certain pathway for a fund to be a qualifying fund.

<u>The test in outline</u>

The GDO test is derived from the UK's Offshore Fund rules or "OF" rules, which provide an established method for determining diversity of ownership in a funds context. This test focuses on the manner in which a fund is marketed.

In order for a fund to be a qualifying fund under this test, it must satisfy the following conditions A to C:

Condition A. The fund produces documents (e.g. a private placement memorandum), available to investors and HMRC, which (a) state the intended categories of investor and (b) contain undertakings that interests in the Fund will be (i) widely available and (ii) marketed and made available sufficiently widely and appropriately for those categories of investors.

- Sponsors must ensure that fund documentation clearly contains the statement and undertakings required by Condition A. This may mean closer attention to this point in fund documents (please see below regarding fund documents in the context of a QAHC established later in the life of a fund).
- For funds marketed prior to 1 April 2022, Condition A is treated as being met if the fund manager produces a statement (as opposed to having to rely on historical fund documents) confirming that interests in the fund were marketed in accordance with Condition A.
- Typical examples of permitted categories of investor, set out in HMRC's OF rules guidance, include the investor bases of most BVCA members: "high net worth [individual] investors" and "institutional investors such as pension funds, sovereign wealth funds and insurance companies". Sub-categories thereof are also permitted provided that, in reality, investment in a fund is "not limited to a few specific persons named or implied by the given categories".
- HMRC guidance states that the requirement for documents to be "available" to HMRC does not require them to be submitted to HMRC, but to be capable of being provided if requested.

Condition B. Neither the stated category of investors nor the fund's terms have a limiting or deterrent effect on investment.

- This is intended to exclude from the GDO test funds whose terms effectively limit investment to a select group within the stated categories of investor or deter a reasonable investor within the target market from investing in the fund.
- Typical examples of such terms include where management fees (and other charges) or minimum investment thresholds are applied to particular investors in a discriminatory way so as to effectively exclude all but a select few. However, HMRC's OF rules guidance makes clear that Condition B is not intended to prohibit normal commercial variations in these areas.
- The fact that a fund may refuse investment to the extent that it exceeds the fund's capacity, e.g. its cap on commitments, is not considered to be limiting or deterrent.

Condition C. The fund is marketed and interests made available in accordance with the statement and undertakings described under Condition A.

- HMRC's OF rules guidance indicates that this condition will be treated as satisfied if the fund actually closes with a substantial number of unconnected investors.
- For funds that close with a smaller number of investors, Condition C can be satisfied in a variety of ways that are largely consistent with a reasonable commercial approach for the fund in question, e.g.:
    - "Some funds may not need to undertake any active marketing to attract the investors identified in the target market, for instance because of the reputation of the fund manager or the success of a prior fund launched by the same fund manager. In this situation, marketing which in practice consists only of discussions with existing investors is capable of satisfying Condition C, provided that there are commercial reasons for marketing in this way and it is not a deliberate attempt to ensure that only a pre-determined group of persons invest in the fund."
    - Otherwise, HMRC will expect to see records documenting a fund's marketing activities and/or a marketing plan that the fund has followed.
    - A focus on attracting only certain, specific investors (e.g. cornerstone investors) for initial closings is permissible, as long as there is, subsequently, further marketing to wider categories of investor within the target market.
    - There is a specific relaxation of Condition C where there is no marketing activity because the fund has no capacity to receive additional investments.

<u>Multi-vehicle arrangements</u>

Changes were made to the original 2022 QAHC rules whereby, with effect from 11 July 2023, a fund that is party to "multi-vehicle arrangements" can meet the diversity of ownership condition if the arrangements as a whole meet the GDO test. Multi-vehicle arrangements are defined as arrangements comprising two or more funds (defined again by reference to CIS or AIF status) under which an investor in one of those funds would reasonably regard that investment as an investment in the arrangements as a whole rather than exclusively in any particular fund.

This is intended to allow the GDO test to be met where funds market an overall structure but provide investors with options for investing via parallel or feeder funds, to accommodate investors who require, for instance, an investment vehicle with particular characteristics or to avoid investing in specific types of underlying assets. The definition of a multi-vehicle arrangement is also seen as applying to aggregator funds, in which the investments of a number of funds are aggregated into a single pool of investments.

4 Key issue – qualifying funds and diversity of ownership

Without the concept of a multi-vehicle arrangement, a parallel, feeder or aggregator fund would be unlikely to meet the GDO test when considered in isolation, but the rules allow the test to be applied to the arrangements as a whole. According to HMRC, this extends to parallel or feeder funds which were not established or incorporated at the time when the main fund was marketed, provided that a reasonable investor would regard the parallel or feeder fund as part of the same arrangement.

HMRC guidance states that a co-investment vehicle which is established to facilitate one or more investors gaining additional economic exposure to a particular investment would not typically form part of the same multi-vehicle arrangement as the main fund. In HMRC's view, a reasonable investor would therefore consider the investment in the co-investment vehicle to be separate from their investment in the main fund. In such a case, HMRC's position is that the GDO condition would need to be considered separately in respect of the co-investment vehicle.

HMRC's guidance at IFM17360 includes examples demonstrating how the GDO test should be applied in certain circumstances involving parallel and aggregator funds.

When must a fund meet the GDO test?

A QAHC is under an ongoing obligation to assess its compliance with the ownership condition. However, insofar as a QAHC's ownership includes a qualifying fund (or multi vehicle arrangement) that relies on the GDO test, HMRC accepts, in its guidance, that this test is generally assessed "once and for all" at the end of the relevant fund's (or arrangement's) marketing period. This is a sensible interpretation of the legislation in the context of a close ended fund but it is helpful to have it confirmed by way of guidance. In addition, from a compliance perspective, this is a key advantage of the GDO test; there is no need for ongoing monitoring of investors etc.

Setting up a QAHC later in the life of a fund

As mentioned above, funds marketed prior to the commencement of the QAHC regime on 1 April 2022 can meet the GDO test if the manager makes a statement about the way in which the fund was previously marketed.

There may be circumstances in which a fund was marketed after 1 April 2022, but was not at that stage considering setting up a QAHC and so did not include the relevant statement and undertakings in its documentation. If the fund subsequently decides to set up a QAHC, there is no statutory provision, similar to that for funds marketed before 1 April 2022, enabling it to meet the GDO test by making a statement at that time.

HMRC's guidance states that it recognises that in some circumstances a fund may need to update documents which already exist to ensure compliance with Condition A. In HMRC's view, provided that the updated documents are supplied to investors, this enables existing funds, established since April 2022, to set up new QAHCs and make use of the GDO test. Nonetheless, if funds are uncertain whether they are likely to establish a QAHC, it may be sensible to ensure that they meet the GDO test during the fundraising process to avoid later complications.

No clearance procedure

BVCA members should be aware that the clearance process for the GDO test in the OF legislation does not apply to the QAHC regime. This is almost certainly because the GDO test in the OF rules tends to apply to funds which need to work closely with HMRC for wider reasons and for which clearance is a standard process. HMRC's guidance states that whether a fund satisfies the GDO test is not something it can confirm under the Non-Statutory Clearance Service, although this service remains available for genuine points of uncertainty. Funds will therefore generally need to reach their own view as to whether they satisfy the GDO test, although this should not normally be regarded as a deterrent to using this route.

The "non-close" test

<u>The test in outline</u>

The term close company is used in UK tax legislation in various instances and generally captures the concept of an unlisted company that is owned by a small number of persons. An amended definition, intended to apply to a corporate fund structure, was introduced in the non-resident capital gains tax or NRCGT rules that came into effect in April 2019.

In the QAHC rules, the term close is applied directly to fund partnerships for the first time. In order to do this, sponsors are required to (i) treat partnership interests in the fund as though they are shares in a company (using a specific methodology) and (ii) apply the close company test (as modified in a similar manner to the NRCGT rules) to the fund.

<u>Summary</u>

In order for a fund to be a qualifying fund under this test, it must not be close. The non-close test under the QAHC rules effectively requires a sponsor to look at the 5 partners with the largest percentage shareholding in the fund and ask whether they control the fund (on the basis of an analysis of both economic and voting "control"). If they do not, the fund should not be close. This test, which comprises two steps, is explored in greater detail below.

Step 1: Treat partnership interests as though they are shares in a (notional) company.

The percentage shareholdings with respect to a fund should be calculated on the following basis:

- Treat the carried interest entitlement as being an interest in income of the fund at the maximum entitlement at all times.
- Ignore a general partner's share and any management fees; ignore decision-making entitlements held by the general partner, fund manager or other adviser that are attributable to their management role.
- Ignore the economic interests of the fund's creditors under normal commercial loans.
- In determining the percentage shareholding held by partners, the control test (see Step 2) looks at both percentage economics and percentage voting. Relevant considerations in this regard include:
    - In the absence of any guidance, it may be reasonable to determine the percentage economics by partners' commitments to the fund, on the basis that partners' entitlements to both ordinary distributions and liquidation proceeds tend to be assessed by reference to the distribution waterfall in a fund agreement.
    - HMRC's guidance suggests that the percentage voting is determined by reference to the voting rights of the partners in relation to residual matters that a GP or fund manager does not control by virtue of its management role, such as: removal of the GP or fund manager; certain amendments to the fund agreement, etc. In most fund agreements, such voting rights are in proportion to the capital commitments of external investors.
    - For any partners in the fund that are transparent (i.e. tax-transparent for purposes of UK corporation tax on chargeable gains), the interests of their underlying interest-holders must be traced for these purposes.

Step 2: Apply the close company test to the notional company (i.e. the fund).

A fund will be close if 5 or fewer participators together control the fund.

- A pragmatic approach in the context of the QAHC rules is to treat each investor that is accorded a percentage shareholding in Step 1 as a participator.
    - BVCA members should be aware that there are technical argumentsto support an alternative position, in the case of an investor that is a partnership, that such partnership itself (as opposed to its

partners, which will be accorded a percentage shareholding in Step 1) is a participator. However, applying this analysis would be inconsistent with the Step 1 methodology set out in the QAHC rules and is therefore unlikely to reflect HMRC's approach to this issue.

- Control generally means the possession of, or entitlement to, >50% of the share capital, income, liquidation proceeds or voting rights in the fund. For these purposes, the interests in the fund of "associated" persons are aggregated.
- The amended close company test based on that set out in the NRCGT rules contains various modifications to suit its application in an investments funds context, including:
  - Partners in a partnership are not automatically treated as associated such that they together comprise one participator.
  - A notional company that is resident in any jurisdiction (i.e. not just the UK) can be close.

<u>When must a fund meet the non-close test?</u>

A QAHC is under an ongoing obligation to assess its compliance with the ownership condition. Insofar as a QAHC's ownership includes a qualifying fund that relies on the non-close test, HMRC considers, in its guidance, that this requires the QAHC to take "ongoing ... reasonable steps" to monitor it. Failure to do so could result in HMRC refusing to permit the QAHC to benefit from any "cure period" in the event of a temporary failure to meet the ownership condition.

What constitutes "reasonable steps" will depend on the particular circumstances of each Fund, but relevant considerations include:

- Lower risk. For a fund with a very large investor base (i.e. no realistic prospect of the 5 largest partners controlling the fund) the QAHC may simply make an annual assessment that the fund remains non-close, e.g. as part of the QAHC's annual audit process.
- Higher risk. For a fund a with a small to medium-sized investor base, the QAHC may need to (i) impose information requirements regarding fund transfers or other indicators of change in investor status and (ii) re-assess the fund's non-close status prior to each disposal of shares in the QAHC (assuming that the disposal proceeds are intended to be treated as capital by virtue of the QAHC rules).

Other remarks

Some funds will comfortably meet the non-close test by virtue of having a large investor base and no more than one or two anchor investors. Such funds may consider that an annual requirement to assess percentage shareholdings, with little risk of actually failing the non-close test (even if, for example, it is conservatively assumed that none of the investor vehicles are transparent), makes this test an attractive one to rely on.

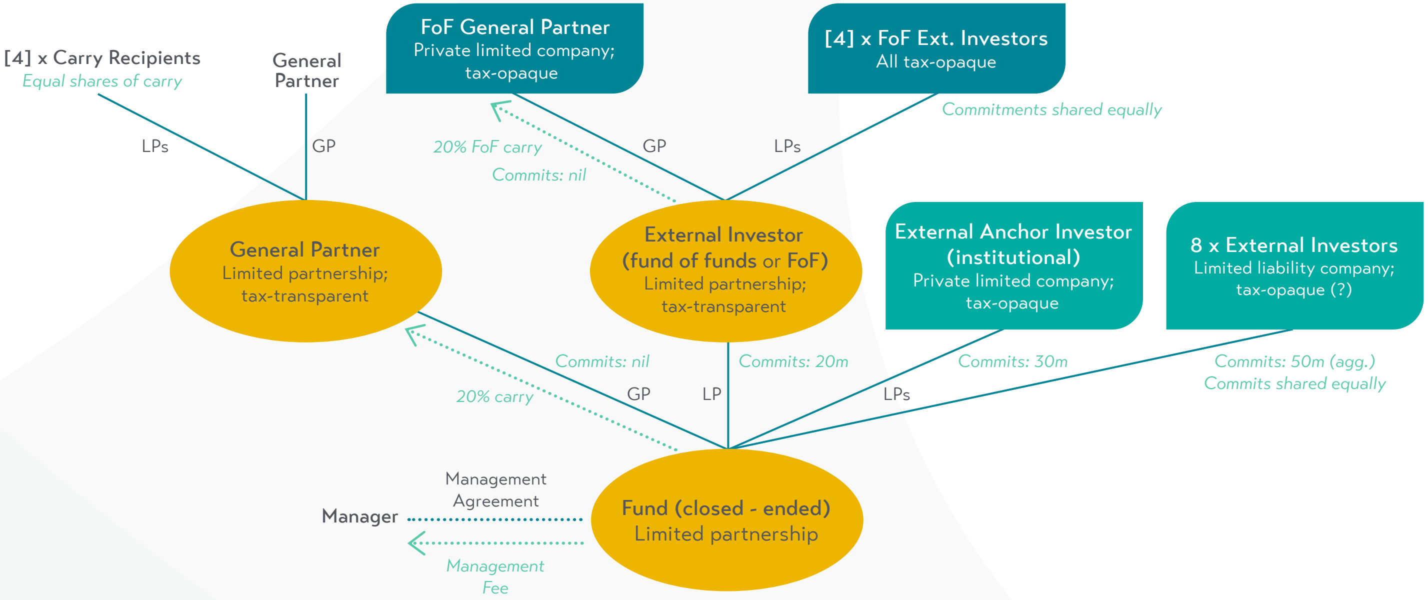
Funds raised by sponsors that are BVCA members may well have a smaller investor base (and may, potentially, have a non-transparent carry vehicle commanding 15-20% of the economics) and, therefore, may not have a great deal of leeway in meeting the non-close test. For such funds, relying on this test may constitute a significant administrative burden, potentially requiring (i) interrogation of investors' structures to assess whether they are transparent, (ii) ongoing, careful monitoring of the impact on the non-close test of transfers of Fund interests and (iii) the keeping of detailed investor records and percentage shareholding calculations. Sponsors of these funds may consider that the simpler, "once and for all" nature of the GDO test makes it a preferable test to rely on.

BVCA members should note that certain common fund structures are unlikely to meet the close company test including:

- A parallel fund or a feeder fund, unless it has an unusually large investor base for such a product. The concept of a multi-vehicle arrangement, relevant to the GDO test, does not apply to the non-close test.
- A separate managed account, which is evidently unlikely to have more than 5 unrelated investors.

4 Key issue – qualifying funds and diversity of ownership

Example of the application of the "non-close" test



Sub-participants	Partner in Fund (direct/indirect)	Commitment (£m) (agg.)	Transparent?	% economics		Voting interests	
				In Fund	In FoF	In Fund	In FoF
	General Partner (Fund carry)		Y	20.00%		0.00%	
4	- Each Fund carry recipent (x4)		N	5.00%		0.00%	
	Fund of funds investor	20	Y	16.00%		20.00%	
	- FoF General Partner (FoF carry)		N	3.20%	20.00%	0.00%	0.00%
4	- Each FoF investor (x4)		N	3.20%	20.00%	4.00%	25.00%
	Anchor investor	30	N	24.00%		30.00%	
8	Each other external investor (x8)	50	N	5.00%		6.25%	
	% shareholding: 5 largest investors			44.00%		55.00%	
				100.00%	100.00%	100.00%	100.00%

4 Key issue – qualifying funds and diversity of ownership

In this example, the 5 largest participators hold 44% of the economics and 55% of the votes, meaning that they control the fund by virtue of their voting entitlements. The fund is, therefore, close and not a qualifying fund.

This example highlights certain ambiguities in applying close company concepts to fund partnerships in order to determine the percentage shareholding in a fund:

- Partners will often hold economic and voting rights in different proportions. How does this square with the QAHC rules requiring partners' rights in the fund to be treated "as if [they] were shares in a company"?
    - In the example, we have taken the approach of treating the partnership interests as giving rise to more than one class of notional share (i.e. an economic class and a voting class). In Step 2, the partners' control of the fund will be assessed on each of these two bases.
    - A sponsor will need to deal with this issue head-on for most funds: percentage economics will take into account carried interest entitlements and house co-invest (if any), whereas the percentage voting will generally ignore these elements because fund agreements tend to exclude sponsor-associates from voting on residual matters.

- The requirement to trace through partners in the fund that are transparent means that a sponsor must address whether each partner is transparent or opaque for purposes of UK corporation tax on chargeable gains. This gives rise to several issues for sponsors:
    - Transparency is not a straightforward assessment for all investor vehicles, potentially requiring the sponsor to scrutinize the laws that legislate for the establishment of that type of fund vehicle (which may not be readily available in English) and/or the governing documents of the fund vehicle (which the investor may be reluctant to provide).
    - In relation to an investor that is itself a transparent fund (e.g. a fund of funds), the carried interest partners in such investor are to be treated as holding percentage economics equal to their maximum carried interest entitlement. This may require an investor to disclose its carried interest arrangements in much greater detail than it would ordinarily expect.
    - Another consequence of the translation of carried interest into percent age economics in this manner is that carried interest held through a tax-opaque carry vehicle will result in one participator holding a (typically) 10-20% economic interest in a fund. This, alone, may significantly adversely affect the outcome of the non-close test.

70% controlled by "Category A investors"

<u>The test in outline</u>

If a fund is at least 70% controlled (directly or indirectly) by Category A investors, it is a qualifying fund under this test.

- The list of Category A investors is set out in Overview – eligibility, above.
- The 70% interest is calculated on very similar principles to the percentage shareholding under the non-close test, including:
    - The same principles apply in terms of converting (a) carried interest, (b) a general partner's or a fund manager's interests and (c) creditor interests, into a percentage interest.
    - Both percentage economics and percentage voting must be calculated on similar principles, except that, subject to the following bullet, the interests of all underlying interest-holders must be traced for these purposes, irrespective of the transparency (or otherwise) of the relevant vehicles.
    - It appears that, for a Category A investor that is a qualifying fund, the interest of the entire fund counts towards the percentage interest held by Category A investors if that fund meets the GDO test; however, if that fund only meets another diversity of ownership test, then only the interests of the underlying Category A investors in that fund count towards the percentage interest.

4 Key issue – qualifying funds and diversity of ownership

- o The concept of control is similar to that under the non-close test. The 70% threshold must be met for all three of the following entitlements: (a) voting; (b) income; and (c) liquidation proceeds.

<u>When must a fund meet the 70% control by Category A investors test?</u>

A QAHC is under an ongoing obligation to assess its compliance with the ownership condition. Insofar as a QAHC's ownership includes a qualifying fund that relies on the 70% control by Category A investors test, it would appear that the same principles apply as under the non-close test, i.e. taking "ongoing … reasonable steps" to monitor the fund's status, determined based on the particular circumstances and risk profile of each fund.

<u>Other remarks</u>

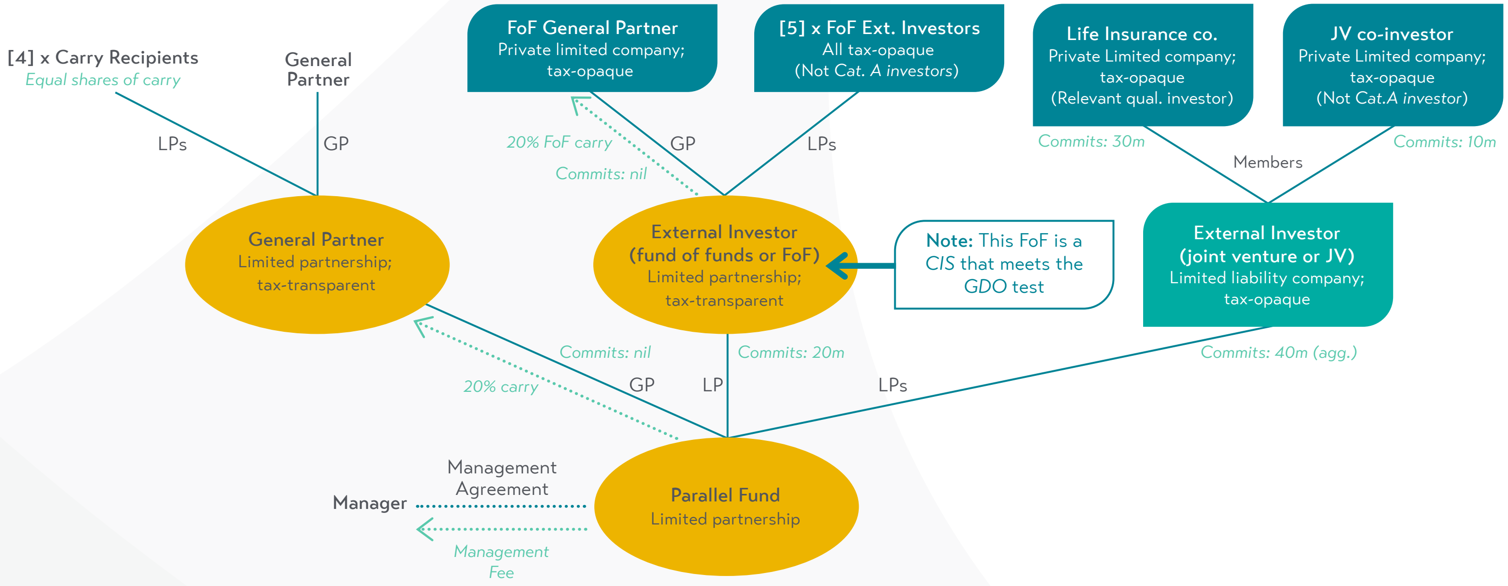
It is anticipated that the 70% control by Category A investors test may enable certain common fund structures that are unlikely to meet the GDO and/or non-close tests, to be qualifying funds, such as:

- a parallel fund that cannot meet the GDO test; or
- a separate managed account (or other fund product designed for a limited number of investors), that is, in each case, at least 70% controlled by Category A investors.

In addition, the 70% control by Category A investors test may give a fund with an appropriate investor base, that is otherwise relying on the non-close test, an alternative basis for being a qualifying fund.

4 Key issue – qualifying funds and diversity of ownership

Example of the application of the "70% control by Category A investors" test



Partner in Fund (direct/indirect)	Commitment (£m) (agg.)	Category A?	% economics In Fund	Voting interests In Fund
General Partner (Fund carry)		N	20.00%	0.00%
- Each Fund carry recipient (x4)		na		
Fund of funds investor	20	Y	26.67%	33.33%
- FoF General Partner (FoF carry)		na		
- Each FoF investor (x5)		na		
JV investor		N		
- Life Insurance company	30	Y	40.00%	50.00%
- JV co-investor	10	N	13.33%	16.67%

4 Key issue – qualifying funds and diversity of ownership

In this example, while Category A investors control more than 70% of the voting (i.e. 83.33%), the rule of interpretation regarding carried interest entitlements means that they do not control more than 70% of the economics (i.e. 66.67%). This fund therefore fails the 70% control by Category A investors test.

This example highlights the following points:

- This test requires the carried interest entitlement (typically 10-20% of the fund's profits) to be treated as an interest in income of the fund at the maximum entitlement. Given that Category A investors have to own at least 70% of the fund economics (because the 70% threshold must be met for both percentage economics and percentage voting), there is very little scope for meeting this test in a fund that pays carried interest (such as a parallel fund) and has material non-Category A investors. This test may therefore be more appropriate for fund products that do not pay carried interest, such as some separate managed accounts.
- When calculating percentage interests for this test, the FoF investor is a 100% Category A investor by virtue of meeting the GDO test, despite having no underlying investors that are Category A investors.

Conclusion on qualifying funds and diversity of ownership

We anticipate that a majority of sponsors that are BVCA members and seeking to use the QAHC regime will aim for their main fund vehicles to be qualifying funds by virtue of meeting the GDO test, which is considerably the most certain and least onerous (administratively) of the three diversity of ownership tests. As stated above, it should be noted that this test has its limitations, for instance in the absence of a clearance process.

Of the other tests, the non-close test is probably the most likely option for fund vehicles unable to use the GDO test, although the 70% Category A investor test may be more appropriate for separate managed accounts. The administrative and monitoring requirements of the non-close and 70% Category A investor tests are significantly greater than for the GDO test and funds will need to bear this in mind. Specifically, if funds consider that a QAHC is a possible option then meeting the GDO test at the fundraising stage may be a sensible option to preserve the availability of this test and its "once and for all" determination.

It is important to reiterate that, although this section deliberately addresses the qualifying fund tests in some detail, it is not a substitute for specific advice on the issue, which should always be separately sought.

5 Specific funds

In this section, the application of the regime to buyout, credit and smaller funds is considered. A QAHC may also be suitable for other types of fund such as real estate and infrastructure funds but these are not dealt with here. It should be noted that, to some extent, the summaries below repeat some observations from other sections; this is deliberately so that they can be viewed in isolation without the need for excessive cross referral.

Buyout funds

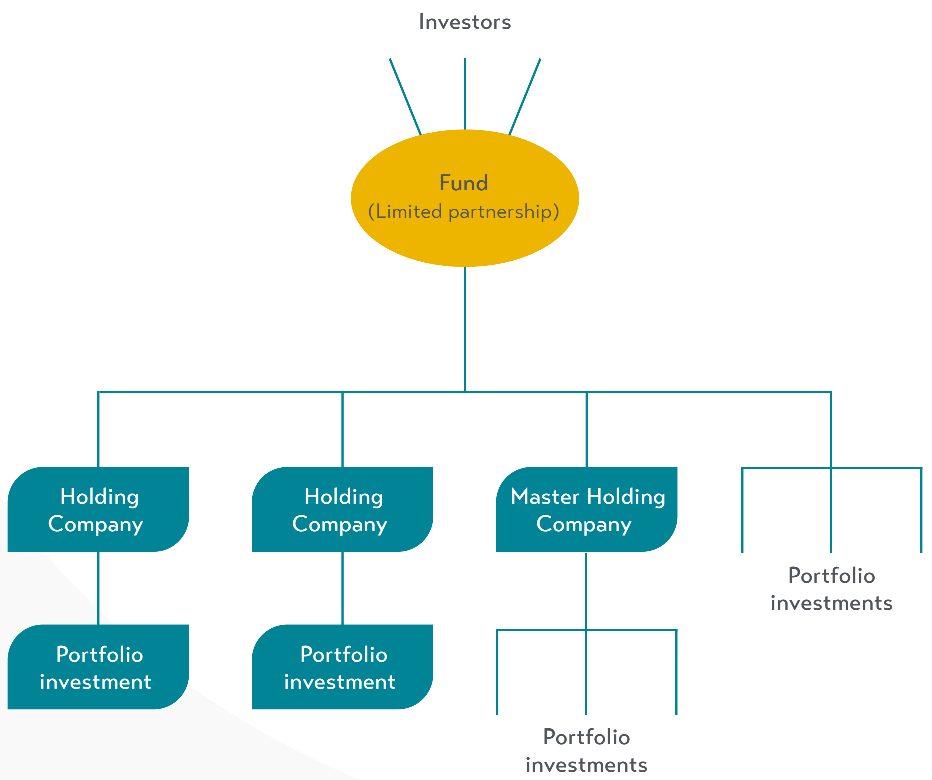
Introduction

Buyout funds have traditionally used holding companies or master holding companies to hold their investments in portfolio companies for a number of commercial, administrative and tax-related reasons. The QAHC regime should provide a viable UK-based alternative to non-UK asset holding companies as a vehicle through which to hold equity and related investments, particularly given the regime's broad exemption from corporation tax on gains on the disposal of shares and allowance of deductions on debt payments that would otherwise be disallowed applying the UK's distribution rules.

The fund limited partnership might establish a simple master holding company through which it would hold portfolio investments, possibly across a number of jurisdictions. It might also establish holding companies for single investments or for a particular type of investment or investments in a particular jurisdiction.
In order to satisfy the general objective of a private fund, that the investors pay no more tax investing in the fund's assets through the fund than they would pay if they invested directly, a fund asset holding company should allow for:

- Capital gains realised on disposal of fund investments being exempt from tax;
- Dividends received from fund investments being exempt from tax and not subject to withholding tax; and

A traditional buyout fund structure



- The holding company being able to claim appropriate tax deductions on its payments to the fund and its investors to ensure that it is subject to tax only on an amount that reflects its activities on an arm's length basis.

Prior to the introduction of the QAHC regime the UK's standard corporation tax regime did not meet these requirements in a number of ways.

- First, while the corporate exemption from tax on capital gains from disposals of substantial shareholdings is meant to provide a broad exemption, its detailed terms and the requirements for a 10% holding, 12 month holding period and portfolio company trading status make it more complex and less attractive than typical participation exemptions in other jurisdictions, particularly Luxembourg.
- Second, the UK's distribution rules apply so that, where interest payment on a UK company's debt is dependent to any extent on the company's business or part of it or is more than a reasonable commercial return on the amount of the debt, the interest is treated as a non-deductible distribution. There has always been concern that debt structured as a typical "profit-participating loan", as commonly used in Luxembourg by asset holding companies to pay all of their receipts (or all of their taxable receipts) to the fund lender as deductible interest, would fall foul of these rules.
- Third, the UK imposes a 20% withholding tax on yearly interest payments, which, while generally possible to structure around, adds some cost and complexity to paying interest from a UK company to a fund.

The QAHC regime addresses these issues as follows.

Corporation tax exemption from gains

The rules contain a simple exemption from chargeable gains arising on the disposal of "qualifying shares" without having to rely on the substantial shareholding exemption. Qualifying shares means any shares unless they derive at least 75% of their value from UK land. Shares includes derivative contracts whose underlying subject matter is shares.

Accordingly, there are no additional requirements to take into account when assessing whether the exemption will apply when a QAHC disposes of shares held for the purpose of its ring-fenced investment business. This is even simpler than comparative European jurisdiction participation exemptions.

Distribution treatment

As mentioned above, interest payments on certain debt instruments of UK companies can be treated as non-deductible distributions.

The QAHC rules state that "relevant distributions" out of assets of a QAHC in respect of securities of a QAHC are not treated as distributions if the QAHC is party to the security for the purpose of its investment business.

Relevant distributions are those paid on "relevant securities". Relevant securities are those that fall within the following:

- They are convertible;
- Interest payments on them depend to any extent on the results of, or of part of, the company's business;
- They are connected with (or "stapled" to) shares of the company; or
- The consideration (e.g. interest, redemption premium) given by the company for the principal secured is more than a reasonable commercial return.

These exemptions should mean that the interest (or other finance cost) on typical debt instruments issued by buyout fund asset holding companies would be tax deductible (subject to the application of any other rule that might disallow the deduction).

No withholding tax on interest payments

Although UK withholding tax on yearly interest payments can generally be mitigated under relevant double tax treaties (and the related HMRC double tax treaty passport scheme) or by listing the relevant debt instrument, this often involves administrative time and cost. The QAHC rules contain a simple exemption from withholding tax on any payment of interest by a QAHC. This aligns the UK QAHC regime with many European jurisdictions that do not levy withholding tax on interest.

Other relevant tax provisions

In addition to the above, the QAHC regime contains other useful exemptions relevant to buyout funds, as set out below.

- There is a simplification of the corporate interest restriction rules to treat each portfolio company group investment of a QAHC as a separate "worldwide group" when the investment is held as a "market value investment" so that group debt ratios are assessed on an investment by investment basis rather than aggregating all controlled investments held by the QAHC. In addition, all QAHCs in a holding stack are treated as a worldwide group.
- A payment made by a QAHC on a repurchase or redemption of its shares is not treated as a distribution except if the shares are held as employment-related securities by individuals who do not provide investment management services in relation to the ring-fence business of the QAHC. Accordingly, this exemption applies to employees of the fund manager on, for instance, carried interest receipts but not to employees or directors of the QAHC's investments in which the QAHC has at least a 25% interest. This provision allows for partial capital returns to investors without the need to liquidate to secure the capital nature of the return.
- The transactions in securities rules do not apply where they would otherwise apply only because of transactions in securities of a QAHC.
- The late interest deduction deferral rule does not apply to debt of a QAHC for the purpose of its ring-fence business.
- There is no stamp duty or SDRT on the repurchase by a QAHC of its shares or securities.
- In order to simplify the tax position of a QAHC, transfer pricing rules apply to all transactions between a QAHC and its investors and the small and medium-sized enterprise exemption is turned off. In practice, this means that the QAHC should only be subject to corporation tax on what is effectively an arm's length margin on its activities.

Acquisition stacks

One other point on QAHCs as buyout asset holding companies is the question of whether QAHCs can be used for each company in the multi-company stack that will generally be set up when a fund acquires a UK investment. While it is possible to stack QAHCs (because a QAHC is a Category A investor for another QAHC) one of the limitations to the ring-fencing of the business and tax treatments of QAHCs is that group relief cannot be surrendered by or to a QAHC from or by a non-QAHC. This means that where a fund acquisition is partly debt funded, with debt being advanced to the company making the acquisition, that company cannot be a QAHC if the intention is for its finance costs to be surrendered to the target group.

Even if the debt is retained within the acquisition stack to fund completion liabilities rather than being advanced to the company, the acquisition stack would typically have tax losses to surrender in this scenario (due to the deductible interest payments on the debt); these losses would then be ring-fenced in the acquisition stack and unable to be surrendered to the target group.

Remittance

As discussed in more detail in Overview – consequences above, the QAHC rules also contain a change to the remittance basis provisions in that, when a QAHC holds non-UK investments, the returns from those investments can be treated as non-UK source when paid out by the QAHC to the investment management team. As with all remittance basis receipts, the fund investors receiving payments from QAHCs will have to manage their receipts carefully to ensure no unexpected adverse consequences.

In summary, the tax changes applicable to QAHCs mean that they are becoming increasingly popular UK-based alternatives as master holding companies or single or multiple investment holding companies, particularly where the related fund management business operates largely in the UK.

Credit funds

Introduction

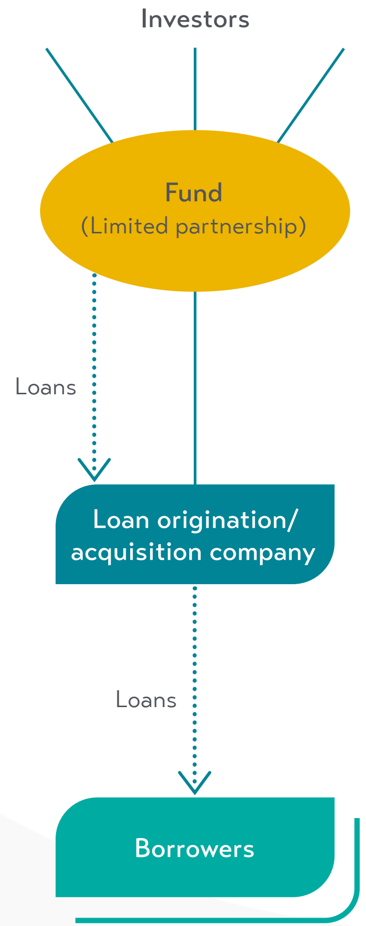
Credit funds are likely to use QAHCs as their primary debt origination or acquisition vehicle rather than as a holding company.

The QAHC regime should provide a viable UK-based lending vehicle given the factors below.

- The allowance of deductions on debt payments that would otherwise be disallowed applying the UK's distribution rules.
- The exemption from withholding tax on interest payments.
- The ability to pass on profits from distressed debt gains on a, broadly, tax neutral basis.
- The simplification of the application of the corporate interest restriction and anti-hybrid mismatch rules.

A typical credit fund structure

The fund limited partnership will establish one or more companies which will, depending on the fund's strategy, make and/or acquire loans and will be principally debt funded. It is this (or these) lending company(ies) that might benefit from being established as a QAHC.



5 Specific funds

The QAHC regime's tax benefits can make QAHCs popular choices for credit funds and provide certainty that the QAHC should only be subject to corporation tax on what is effectively an arm's length margin on its receipts that would reflect its activities and risk profile as a relatively passive debt investment company.

Distribution treatment

Interest payments on certain debt instruments of UK companies can be treated as non-deductible distributions.

The QAHC rules state that "relevant distributions" out of assets of a QAHC in respect of securities of a QAHC are not treated as distributions if the QAHC is party to the security for the purpose of its investment business.

Relevant distributions are those paid on "relevant securities". Relevant securities are those that fall within the following:

1. They are convertible;
2. Interest payments on them depend to any extent on the results of, or of part of, the company's business;
3. They are connected with (or "stapled" to) shares of the company; or
4. The consideration (e.g. interest, redemption premium) given by the company for the principal secured is more than a reasonable commercial return.

These exemptions should mean that the interest (or other finance cost) on typical debt instruments issued by credit fund QAHCs should be tax deductible (subject to the application of any other rule that might disallow the deduction). The provisions should allay fears that the basic corporation tax regime applied to credit fund lending companies might result in distribution treatment for interest paid by the UK company on advances to it used to make/acquire its loans, even when the lending company is just making fixed or floating rate loans. While HMRC comfort has been obtained on occasion in the past that the lending company would not be treated as paying "results dependent" interest in these circumstances, the general concern has meant that UK companies do not tend to be used for this sort of lending activity. This concern has now been removed for QAHCs.

Hybrid mismatch rules

The simplification of how the anti-hybrid mismatch rules might apply to interest payments paid by a QAHC make it clear that any mismatch that might arise on relevant securities that have distribution treatment turned off as described above will not be treated as arising from any term or any other feature of the QAHC's securities so that no disallowance will arise under the general deduction/no inclusion mismatch rule. This would still leave possible disallowance under, for instance, the hybrid payee rules, but does simplify significantly the potential application of the anti-hybrid rules to QAHC lending companies.

No withholding tax on interest payments

Although UK withholding tax on yearly interest payments can generally be mitigated under relevant double tax treaties (and the related HMRC double tax treaty passport scheme) or by listing the relevant debt instrument, this often involves administrative time and cost. The QAHC rules contain a simple exemption from withholding tax on any payment of interest by a QAHC. This aligns the UK QAHC regime with many European jurisdictions that do not levy withholding tax on interest. Obviously, this is extremely important for credit funds.

Corporate interest restriction

In addition to these simplifications, the way that the UK's corporate interest restriction rules work outside the QAHC regime mean that the tax-adjusted EBITDA amount relevant to determining the disallowance of deductions should include any profits made on debt acquired for less than its principal amount. This should, subject to accounting analysis, mean that QAHCs would be suitable as distressed debt acquisition vehicles as well as loan origination vehicles, which might not be the case for other jurisdictions.

Trading issues

The main concern that has been raised with using QAHCs as credit fund lending vehicles which is not covered by the specific tax provisions is whether they might be treated as trading or as having more than insubstantial trading activities by analogy to the lending activities of a bank. This is particularly the case where the company generates fees, such as arrangement or syndication fees. HMRC's guidance provides reasonable comfort on these points, although it states that the position remains fact specific. As a result, the QAHC regime could well make the UK an attractive alternative to other jurisdictions as the place of establishment for fund lending vehicles.

Smaller funds

There is no ready definition of a small fund, what is small to one person could be large to another. The term smaller fund is more useful in this context as additional issues and challenges arise under the QAHC regime as the size of the fund get smaller based on the profiles of the funds encountered.

A key issue is that, as funds gets smaller, the scope for diversity of ownership of the fund (discussed above at Key issue – qualifying funds and diversity of ownership) becomes more of a challenge and certain specific issues assume a greater importance. Smaller funds may well include a larger constituent of UK non-corporate investors such as high net worth individuals and perhaps a largely UK executive team, all of whom may be interested in capital return treatment. However, such individuals will not be Category A investors, so that the 70% Category A investor test of diversity of ownership may not be possible. In addition, very small funds may well be "close" and it may be more challenging for a smaller fund to be certain of meeting the GDO test "marketing" requirements, especially if it secures a cornerstone investor initially and then subsequently seeks to "market", a point not well addressed in the GDO test. Furthermore, remittance basis issues may be more relevant to high net worth anchor investors or executives so that the regime itself becomes unattractive as discussed above in Overview – consequences.

For transactions where management retain a material interest in the business (probably more common in investments by smaller funds), management would also not be expected to qualify as a Category A investor, and accordingly, the companies in the structure capable of qualifying as a QAHC may be limited to a top holding company above the level at which management participate (e.g. if the management percentage breaches the 30% limit). Another difficulty from a management perspective is that the limitation on the share buyback capital treatment for management may discourage use of the disposal benefits in any event.

A potentially attractive application of QAHCs for smaller funds may be use as a co-investment vehicle to bring together several co-investing funds, where a transaction is too large for one fund alone, subject to the ownership conditions being met. Another application may be as a vehicle for introducing bridging debt, with the QAHC having advantages over the existing choice of SPVs.

6 Conclusion

The introduction of the QAHC regime represents one of the most exciting positive developments in the arena of funds taxation for many years, and is a significant opportunity for the UK to regain its position as an attractive location for asset-holding vehicles. Sponsors will need to consider their situation carefully, as some elements of the QAHC eligibility criteria, in particular the ownership condition, may present challenges. A QAHC may not be the answer in every circumstance, for instance if relief from withholding tax under an EU Directive is a key requirement. Nonetheless, the QAHC regime has generated considerable interest and the number of QAHCs continues to grow.

The BVCA was heavily involved in discussions with HMT and HMRC at all stages of the development of the QAHC regime, including in resolving a number of residual issues with the original rules. Inevitably, as the regime beds down, further detailed technical issues continue to emerge and the BVCA's dialogue with the Government continues. Members are encouraged to contact the BVCA with any technical issues they may encounter, so that these can be fed in to this ongoing process.

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