Asset holding companies consultation
Corporate Tax Team
HM Treasury
1 Horse Guards Road
London SW1A 2HQ
By email: ukfundsreview@hmtreasury.gov.uk

19 August 2020

Dear Sirs,

**Re: BVCA response to the HMT consultation on the tax treatment of asset holding companies in alternative fund structures**

We are writing on behalf of the British Private Equity and Venture Capital Association ("**BVCA**"), which is the industry body and public policy advocate for the private equity and venture capital industry ("**PE/VC**") in the UK. With a membership of over 750 firms, the BVCA represents the vast majority of all UK based PE/VC firms, as well as their professional investors and advisers. Over the five-year period 2014-2018, BVCA members invested over £38bn into nearly 2,800 companies based in the UK. Our members currently back around 4,330 companies, employing close to 1.6 million people on across the world, including 843,000 in the UK.

We are grateful for the continued engagement on the areas raised in the consultation on the tax treatment of asset holding companies in the alternative fund structures (the "**AHC consultation**"). Set out below are our detailed comments to the questions in the consultation document and we look forward to discussing these further with you.

**Summary feedback**

The UK hosts the most important PE/VC ecosystem outside the USA, which generates significant numbers of highly skilled jobs and adds a significant dimension to the country's global importance as a financial services hub. However, in an ever-complex operating environment the tax, legal and regulatory advantages of establishing a PE/VC fund and/or manager in the UK have been eroded as overseas jurisdictions developed more favourable regimes (such as Luxembourg or Ireland) and the UK has not kept pace with these developments. There are plenty of jurisdictions which welcome UK fund managers with open arms and, particularly in light of Brexit, continue to evolve and strengthen their operating frameworks to ensure their country remains competitive with the UK PE/VC industry.

The BVCA warmly endorses the government's commitment "to the ongoing success of the asset management industry" and the wider review of the UK funds regime designed to "ensure the ongoing competitiveness and sustainability of the UK regime" (paragraphs 1.3 and 1.5 of the AHC consultation). We welcome the AHC consultation, and the government's readiness to change the UK tax regime in response to the consultation to remove the barriers to the use of UK companies as asset holding vehicles, both as a positive development in its own right and also in earnest of the wider review.

Facilitating the use of UK companies to hold fund assets is an important and necessary first step in restoring the competitiveness of the UK as an asset management centre, but it is not by any

means sufficient. It is necessary because the cumulative effect of the OECD BEPS project and other international tax developments is to put a premium on jurisdictions where there can be co-location of functions, i.e. where a fund management business, fund and asset holding vehicle (where required) can all be based. This makes it unlikely that the UK would be a jurisdiction of choice for a fund manager without offering a UK asset holding vehicle. This is a critical development as over time regulatory regimes are likely to require more senior personnel to be based in the relevant location and therefore without action the UK will find more value add activities move to the fund location. Whilst it is welcome to see change to the AHC regime, that change alone will be insufficient on its own to restore the UK's competitive position because of the many other weaknesses of the UK. As we have repeatedly made clear in our Budget submissions, other necessary measures include:

- concluding proposed reforms to UK limited partnership law to remove ongoing uncertainty that, alongside unnecessary tax reporting requirements and other challenges, is reducing the popularity of UK fund structures;

- reducing the costs, complexity and uncertainty associated with our tax and regulatory framework and a recognition of the significant additional compliance burden associated with unnecessarily broad implementation of new legislation. In particular, review the treatment of PE/VC firms within the scope of the Investment Firms Regulation and Directive given its disproportionate and UK-specific impact;

- ensuring that the UK regime for taxing fund managers remains competitive and improving the position of non-domiciled managers to increase the UK's attractiveness;

- speeding up FCA operational processes across a number of areas including the authorisation process, Alternative Investment Fund Managers Directive ("**AIFMD**") filing processes, and change of control approvals. This is an easy win that would powerfully reinforce the message in a visible way that the UK is a friendly environment for the global PE/VC investment community.

Our detailed responses to the AHC consultation are set out in the body of this letter, but we would like to make some preliminary comments. Firstly, any UK AHC regime must be:

**Comprehensive**. It is a cardinal principle of the funds industry that participants should not be worse off participating through a fund than if they had acquired its underlying investments directly. The new regime must eliminate any risk of a UK asset holding vehicle creating a tax liability or (as far as UK participants are concerned) altering the tax treatment of their returns (in contrast to the position if they had held portfolio investments directly).

**Clear**. If there is any risk of UK AHCs creating a tax liability or the benefits of the UK AHC regime not being available, fund managers will simply avoid using UK AHCs. So, the implementing legislation must be as simple and clear as possible. To the extent there are gateways (conditions to being able to access the new regime) they should be clear and objective (and not, for example, undermined by a broad, subjective targeted anti-abuse rule) and funds should be able to obtain clearances in any areas of doubt.

**Consensual**. A significant amount of time will typically elapse between making and realising an investment. Fund managers need to feel confident that any attractive UK AHC regime in place when they invest will still be in place when they come to dispose of investments. A key feature of jurisdictions (such as Ireland and Luxembourg) where funds and AHCs are based is a broad

measure of political, legal and tax stability. To the greatest extent possible, a message that UK AHCs are uncontroversial vehicles with a broad measure of political support would be important in making them attractive to potential users. The stability of an AHC regime is a critical component and source of competitive advantage. If investors do not believe that the regime will last, then it will not succeed in its objectives. There needs to be a long term commitment by the UK to deliver a stable regime.

Secondly, as a trade body, we have surveyed our members. We refer to particular findings in the course of our letter, but it would be fair to say at the outset that there is a significant level of support among our members for this exercise. A material proportion of survey respondents who currently have non-UK AHCs would be interested in moving to use a UK AHC if an attractive regime could be developed. A number of members are UK based but forced to use non-UK AHCs because of the difficulties presented by the current UK regime. Whilst this exercise may not be sufficient to make the UK a compelling jurisdiction for a fund manager not currently based here, an attractive UK AHC vehicle would be used by funds and fund managers already based here and take away a factor which could lead to them reducing the future scale of their UK activities (which would be the case if they continued to use a non-UK AHC and were compelled or felt the need to bolster its substance and role).

This response covers the fund strategies within the BVCA's spectrum of interest, being private equity and venture capital. Given the overlap between private equity fund strategies and various lending strategies, some comments extend to credit funds also.

**Member Survey**

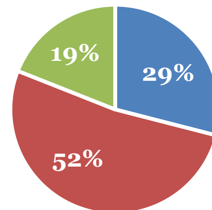
The BVCA has polled its members on a variety of questions raised in the AHC Consultation. The survey was circulated at a challenging time, with Covid-19 matters testing the schedules of the member community, however 22 responses were obtained. There was a broadly equal sample within tiers of firms managing or advising AUM of less than £1bn, AUM of £1bn-5bn and £5+bn of AUM. All firms, regardless of the size of AUM managed or advised, raised money from a diverse range of investors by type and location. The most common type of investor was pension funds; followed by family offices, fund of funds and private individuals. Insurance companies, sovereign wealth funds, government agencies and endowments/foundations were also important investors. The majority of firms had UK, continental European and USA investors, with some also having investors from the Middle East, Asia, Australasia and South/Central America (in order of popularity).

Luxembourg was the most popular choice for overseas AHCs. Funds using Luxembourg AHCs invested in both the UK and continental Europe, with some also investing even further afield. Luxembourg works as a destination for AHCs due to the range of entities available and compares favourably to the UK as we outline later in our response.

Importantly, there is overwhelming sentiment that a new regime for AHCs would be welcomed. A large majority, 85% said that they would move their AHC platforms to the UK if a more favourable regime were introduced. This view is consistent across larger and smaller funds. Where the answer was no to this question, it was noted that it is not a binary decision and the answer would be influenced by a range of factors (commercial, legal and tax).

Interestingly, with an appropriate new AHC regime, there would be enthusiasm to change the location of the AHC in both current and new fund structures.

If a more favourable regime was implemented in the UK and you considered moving AHCs to the UK, how long would it take to change the location in either current or new fund structures?




The respondents did emphasise in free text comments that their enthusiasm to adopt a UK AHC platform was dependent on the regime being fully fit for purpose and dependable. Other feedback highlighted the current level of tax uncertainty in UK as being very unattractive to managers. We have commented in many Budget submissions on the importance of stability and predictability in the tax regime if the UK is to be an attractive location for investment generally and fund vehicles in particular. All of this is reflected in our opening comment that any UK AHC regime needs to be clear, comprehensive and consensual.

## Response to consultation questions

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

### Role of AHCs in PE/VC funds and commercial and tax benefits

Based on our survey results the majority of respondents either always or usually use an AHC to hold their investments. The role that an AHC plays in fund structures is wide-ranging and designed to manage the legal, regulatory, administration, finance and tax issues that arise.

There are a number of commercial benefits to using a corporate vehicle to hold investments, interposed between a fund limited partnership and the operating portfolio companies. One of the most important legal benefits of an AHC is the ability to create a legally distinct entity from the investment fund. This corporate veil protects the fund itself and further limits liability of investors that might arise in relation to investments. This ring-fencing also extends to banking covenants.

It also acts as a platform for multiple investments with capital and shareholder debt consolidated through the fund and acts as the contractual party when buying and selling investments. The AHC supports underlying investments securing external debt by providing security over the debt, as well as funnelling shareholder debt to the portfolio companies. It can also consolidate hedging and forex movements which in a UK context is important for pan-European or global investments.

Also as recognised in paragraph 2.11 of the AHC Consultation, AHCs can assist as a platform for co-investors, joint ventures or multi-partnership funds to make an investment in specific fund investments.

AHCs supervise investments at a more detailed but strategic level, for example considering changes to management, assessment of business changes, assessing add-on, refinancing and carve-out opportunities for presentation to the investment advisor and/or Investment Committee. AHCs are effective in pooling knowledge across investments, for example if a particular AHC is used for investing in particular geographies. Teams in AHCs may also be involved in cash management of proceeds of realisations and part realisations, in particular where re-deployment is mandated by the fund documents. Furthermore, AHCs will often be used as the appropriate point in the structure for co-investors to take their participation.

From an administrative perspective, investing through a single entity AHC provides administrative ease. The AHC centralises the control of the fund's investments and enables better management and oversight. A corporate vehicle assists cash management receiving investment returns following realisations, which can either be distributed or re-invested (depending on the provisions in the Limited Partnership Agreement governing the fund).

As mentioned, the concept of tax neutrality, not creating incremental taxation in the fund structure, remains a key principle not only in relation to the fund but also the AHC. The ability to avoid layers of withholding tax and, in some cases, reduce the exposure of investors to capital gains taxation on investments in some territories is vital. AHCs can help with this, but it is important that the interposition of an AHC does not subject the fund investors to a material amount of additional taxation that would not have been suffered by them if the investment had been made directly. So, the AHC would typically be located in a jurisdiction offering access to wide range of tax treaties and / or EU Directives to manage withholding tax exposure in source territories. The AHC will typically also benefit from participation exemptions as regards dividends received and disposal proceeds.

## Advantages over direct investment

As many investors in funds are sovereigns, pension funds or other tax-exempt entities it is crucial that only minimal taxation should be suffered in the fund structure; otherwise it would become very tax inefficient for these investors to invest via co-mingled funds as opposed to directly. An AHC can be used to make sure that such investors are not prejudiced by investing in a fund and can also help to manage compliance, as withholding tax exemption claims etc can all be handled centrally by the AHC without needing to burden individual investors with the need to make their own claims etc.

## Typical PE fund structures

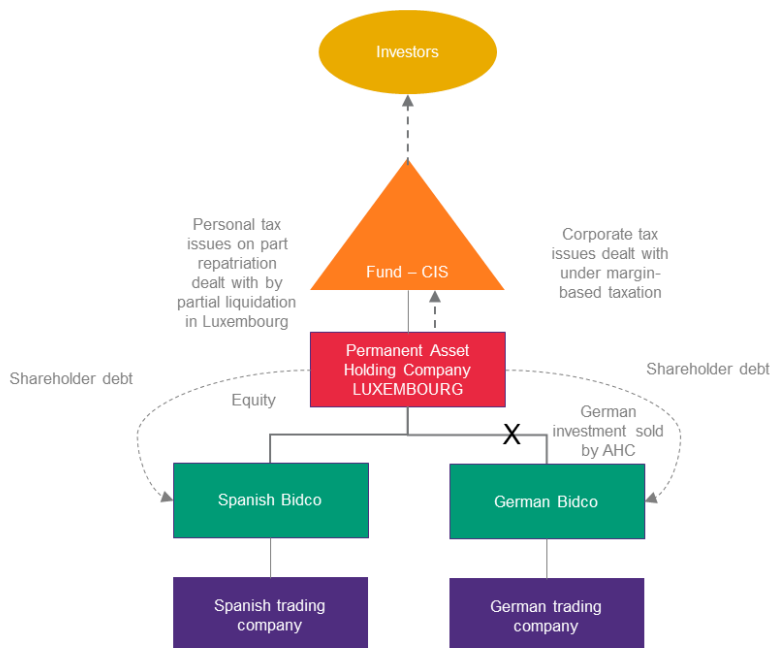
Paragraph 2.10 of the AHC Consultation asks whether the characterisation of AHCs represented by the structure diagram is appropriate. We consider that the characterisation is accurate, in general. However, with reference to the diagram it is important to distinguish between the AHCs and the Bidcos and other holding companies typically used to effect an acquisition of an investment.

In the example we provide below, the AHC is used by the fund to hold multiple investments. The diagram shows that the acquisition will typically be made by one or more further local holding companies, to accommodate the various levels of financing and structural subordination. Unlike

the AHC, the Bidco, and any superior local holding companies, will typically be disposed of or liquidated when the investment is “exited”. Co-investors are equally likely to come in at the level of a Bidco / local holding company rather than at the AHC, if they wish to have exposure to a particular investment only.

There are a number of elements to investment structures however, of which AHCs are a part, and many of these will involve entities incorporated or established outside the UK. These elements are as follows:

- The fund, the entity via which the participations of investors are collected and invested in portfolios
- The AHCs, which may be formed to hold multiple investments, and which are held under the fund
- Other holding entities, such as Bidcos formed to borrow from third party and shareholder sources and make an acquisition
- Entities involved in management or advisory activities related to the fund.




## Why AHCs have been situated outside the UK

To understand why AHCs have been situated outside the UK, it is first important to understand why funds have frequently been domiciled outside the UK. There are various reasons for this, notably:

- Regulatory considerations regarding access to the AIFMD marketing passport, which has become more important for some PE/VC firms since Brexit and the forthcoming end to the transitional period
- The panoply of different entity types available e.g. in Luxembourg, with various combinations of fiscal and legal transparency and associated regulatory and VAT regimes (such as the SICAR and RAIF variants in Luxembourg).

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- The UK VAT regime in respect of investment management and advisory services and recovery of associated input VAT has in some cases been a deterrent.

Commonly, it will be desirable to locate the AHC in the same location as the fund, from a commercial perspective, to avail of directors and support services in the same country, and from a tax perspective, since the use of a single jurisdiction better evidences the rationale behind the AHC as part of the overall fund structure and renders it easier to operate as required to obtain treaty, directive, or similar reliefs."

As this response goes on to detail, the key reason AHCs have not been located in the UK is that other regimes have clear bright lines so there is certainty around qualifying for a beneficial tax regime. For example, Luxembourg's participation exemption qualification is an easy test to understand compared to be UK regime. Furthermore, there is more uncertainty in the UK about the endurance of regimes from one government to the next.

As will be described further below, a UK AHC would in many cases currently result in material tax leakage, and is therefore seldom used.

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

This response is focused on private equity and venture capital investment structures referred to in the AHC consultation. In addition to the other asset classes that this consultation exercise identifies (credit and real estate), infrastructure (to the extent not covered by real estate) and hedge fund assets are likely to be the fields where AHCs are also highly prevalent.

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

The UK has a thriving investment management and asset management industry. However, as noted above PE/VC managers generally choose non-UK entities for various functions within the overall structure, in particular where the business makes investments in overseas territories. As the AHC Consultation recognises, various tax factors have impeded the attractiveness of the UK as a place to locate these entities.

### Economic benefits to the UK

We do, however, believe that increasing take-up of AHCs in the UK could start to bring some proportion of the revenues and economic benefits seen in key investment management locations such as Luxembourg and the Channel Islands.

Staff needed to service UK AHCs would contribute to the Exchequer via PAYE income tax and national insurance contributions. There is also a benefit to the UK's professional advisory businesses as the greater use of UK entities will require more UK legal, accounting, tax and administration services leading to job creation and associated tax revenue. Our survey responses have highlighted the benefits for the UK fund support services industry, which has depth and quality, and UK fund managers are keen to make increased use of UK-based providers, which would be expected if AHCs were increasingly located in the UK. Luxembourg, in particular, is a problematic jurisdiction in terms of professional services. Members report significant frustration at the costs, delays and inflexibility of operating through that country, and would readily base funds and AHCs in the UK if there were an appropriate, stable regime here.

The following factors result in Luxembourg being an expensive location to operate AHCs.

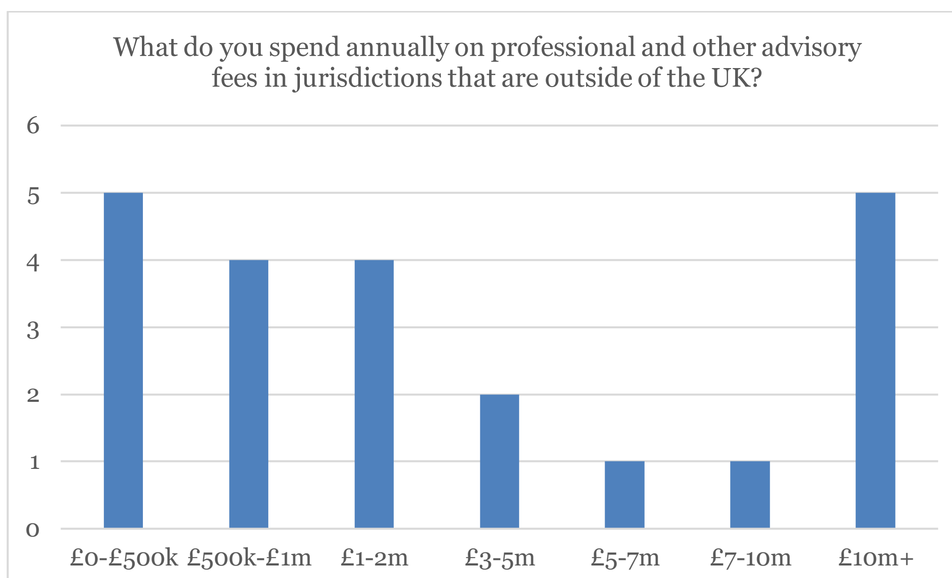
- As the concentration of investment activity in Luxembourg has increased, so too have the costs of engaging local support services. Obtaining the support of local company secretarial and governance services is high. Aside from the financial cost, given the increased level of demand and the need to hire and train staff, there is an inevitable time lag for recruitment or in the service level provided by professional advisers.
- Luxembourg law requires a number of processes to be notarised. Whilst the cost of this is not prohibitive except for the smallest users, it is a time consuming and administratively burdensome process. As an example, the subscription for shares commonly needs to be notarised in Luxembourg.

The AHC will typically require the following services, some of which typically involve the PE/VC firm's own resources, and others which are sourced from third party providers.

- Director services. These will typically be internally sourced, in particular with the larger asset managers. However, additional directors permanently resident in the AHC territory may also be involved. Sometimes, directors' services may be provided by local administrators.
- Administration. The flow of cash requires monitoring and reporting, together with entity management accounts work and input into the investor reporting for the investments concerned and financing passing through the AHC.
- Legal services. The AHC will need to comply with company law and will need to seek advice relating to transactions undertaken by it.
- Accountancy advice. The AHC will typically need to file audited accounts.
- Taxation advice. The AHC will have to determine the tax it has to pay and make appropriate tax filings.

To deliver these functions there may be a number of individuals retained by the AHC either as employees, directors or consultants. Over 40% of firms that answered our survey question on employment in the jurisdiction where the AHCs are located employed between 1-10 people and 22% employed more than 40 people.

There is a variability of spend by the different firms in our survey on total professional and other advisory fees in jurisdictions outside of the UK and in aggregate these are significant. In terms of spend on professional services in the territories where AHCs are typically located, our survey has indicated that very significant amounts are spent in these territories.




We also asked respondents to confirm how much of the non-UK spend was attributable to the AHCs. Not all respondents were able to provide this information easily (it may be difficult to unravel fund and AHC spend), so it is difficult to conclude decisively. However based on the feedback that was provided by some firms, a significant proportion of the costs could be attributable to the AHC.

As recognised in paragraph 2.14 of the AHC Consultation, the tax revenue from individual UK AHCs may be relatively modest being the margin between back to back funding and profit on intercompany services. However as also noted in the consultation, collectively this may be a significant amount. As far as local taxable profits are concerned, this is particularly challenging to estimate given the private nature of the underlying data.

The benefits of an attractive and certain AHC regime will build over time. Initially with any new regime there will be some uncertainty as to whether to use it as well as the difficulty of migrating investments from other AHCs. However, some funds may take up the use of a UK AHC immediately which in turn will build confidence amongst other funds. The majority of respondents to our survey, 81%, expect changing the location in either current or new fund structures to take up to two years.

## Other benefits

If UK AHCs could be used, this would help firms to address the pressures BEPS Action 6 has created in ensuring treaty eligibility. The need to demonstrate what is colloquially referred to in the collective term “substance” by means of such things as a clear purpose in the context of the overall business and autonomy over the finances and operations of the entity necessitates a certain level of activity and economic presence in the relevant jurisdiction.

This approach can lead to “co-location”, where funds, AHCs and asset managers themselves look to be established in the same jurisdiction. Housing everything in one jurisdiction, and in particular the UK, is important in executing a transaction as anything that causes “grit in the wheel” poses transaction risk. Given the substantial other activity that happens in the UK, e.g. banking, encouraging more co-location offers further efficiencies. A UK-based manager would find a UK AHC attractive because there is already (and very naturally) substance in the UK. However, if an AHC is needed and the UK is not a viable jurisdiction, these pressures will lead to UK-based

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functions and employment being diverted to the chosen AHC location. An attractive and stable UK AHC regime will be a valuable defensive ploy against this.

We also cannot ignore the benefits of having less reason to fly on a frequent basis, noting sustainability concerns and the experience of firms during Covid-19. This coupled with the fact that Luxembourg does not have direct flights to New York puts the UK in a better position.

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

### Challenges of using a UK AHC

Based on our survey results, the most popular location for AHCs is Luxembourg. Luxembourg AHCs were mostly used by managers or advisers of funds with AUM in excess of £1bn. It is not surprising that it is favoured by the larger firms, given the relatively higher costs of support services in Luxembourg compared with some other AHC territories.

It is recognised that there are multiple challenges in making the UK a more attractive location for fund managers. The desire to retain existing EU regulatory passports under AIFMD and investor demand for an EU structure, has meant that many PE/VC firms have established AIFMs and AIFs in EU jurisdictions, notably Luxembourg. The cumulative effect of the OECD BEPS project and other international tax developments is to put a premium on jurisdictions where there can be co-location of functions, i.e. where a fund management business, fund and asset holding vehicle (where required) can all be based. Therefore for some firms it may not be attractive to locate AHCs in the UK. In that context the interaction between the UK and EU regulatory authority will be critical post Brexit as potentially more senior resource will be required to locate within the EU and that has implications for the success of a new AHC regime and the UK as a location for funds and the related advisory activities in the medium and longer term.

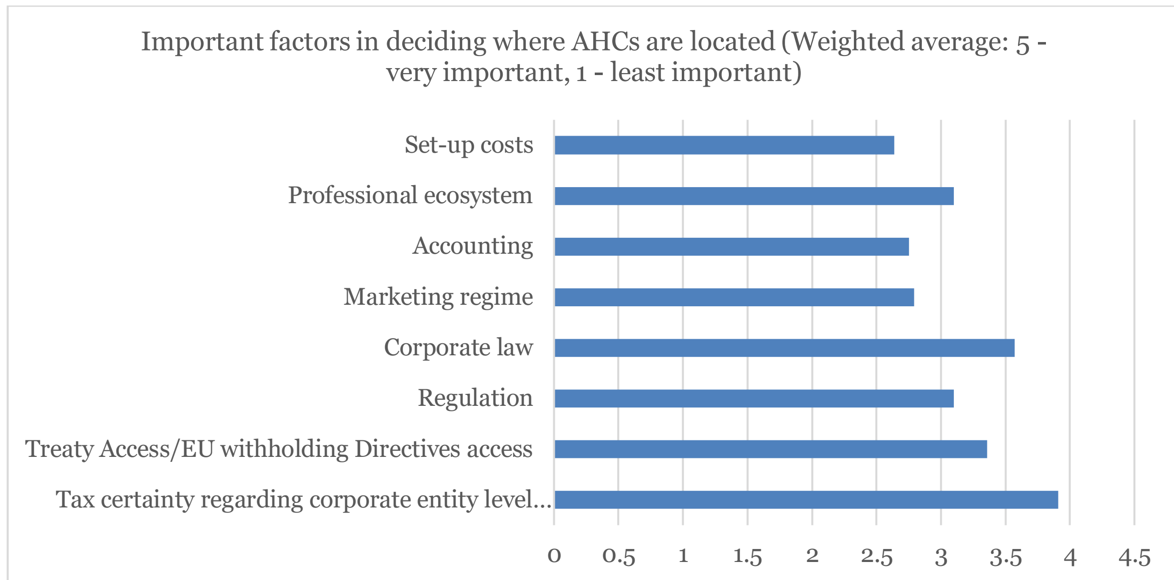
Private equity funds making investments only or principally in the UK will almost invariably wish to acquire investments directly "under" the fund due to various material disadvantages of using a UK AHC. The reality is it rarely happens in practice.

Under current UK tax law there are challenges at both the corporate level in terms of tax leakage and uncertainty, and at the investor/individual taxation level in using the UK as an AHC jurisdiction. Nevertheless if the new regime successfully adopts the changes needed, since the UK does not have dividend withholding tax, the UK may have a substantial advantage over Luxembourg.

PE/VC firms look at a number of different factors when determining the location of AHCs, with the most important factors identified from our survey being:

- Tax certainty regarding corporate entity level entitlements;
- Treaty/EU directives access; and
- Corporate law

Based on our survey results, the first two points were of paramount importance as investors in a fund cannot be in a worse tax position than if they had invested directly, especially where they are tax-exempt investors. Simplicity, certainty and efficiency are necessary attributes of any AHC regime.




We identify the main tax challenges below, and provide more detail on the solutions in our response to Q9. We have also provided, in Appendix 1 a number of case studies to illustrate some of the challenges encountered by managers of private equity and similar strategies in using UK AHCs under the current tax legal framework.

## Summary of key challenges

- **Substantial shareholding exemption:** the narrowness of the UK's Substantial Shareholding Exemption ("**SSE**"), as recognised in paragraph 3.18 of the AHC Consultation creates uncertainty as to whether all of the conditions can be satisfied at the point of disposal (as certainty is needed at the outset of the investment).

- **Hybrids mismatch regime and interest deductibility framework:** The wide-ranging nature of the UK's hybrids mismatch regime creates a variety of potentially unintended consequences in a funds context (as recognised in paragraph 3.33 of the AHC Consultation), where similar structures are treated differently. Coupled with the multi-layered interest deductibility rules such as thin capitalisation and the Corporate Interest Restriction framework, it is challenging for an AHC to predict its likely future tax liability with certainty. Other regimes have developed a well understood framework.

- **UK withholding tax on interest**: Withholding tax on shareholder loan interest creates administrative burdens for investors who seek double tax relief in their own tax filings. For some investors, it creates a final tax cost, in particular tax-exempt investors. Although interest withholding tax can be managed currently through EU Directives and / or tax treaties it does not eliminate the exposure entirely. The issue is typically addressed by listing the loan notes on a recognised stock exchange, however this process takes up time and cost in a transaction context. The materiality of this cost is an issue mainly to smaller asset managers conducting smaller transactions and the historic uncertainty around the quoted Eurobonds exemption creates at least a perception of risk for the larger asset managers who use it.

- **Foreign exchange transactions**: A UK AHC is likely to hold a number of investments in different currencies, therefore taxation on forex gains which are not part of the usual business of the AHC present a potential tax risk.

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- **CFC regime:** The AHC needs to operate in a way that does not risk creating a CFC profit attribution.

- **Taxation of upstreaming proceeds**: As recognised in paragraph 3.28 of the consultation, due to the income treatment of any form of distribution from a UK AHC for individual shareholders (whether or not holding via a partnership), the UK is at a material disadvantage. By contrast, in certain other territories, for example Luxembourg, it is possible to repatriate the proceeds of a disposal of capital assets in a form which is regarded as a capital distribution both locally and in the UK.

### Substantial shareholding exemption

One of the most unattractive aspects of the existing UK AHC regime is the narrowness and complexity of the SSE. The UK's SSE rules are very prescriptive and lack flexibility such that they can impose taxation in circumstances where other participation exemptions would not do so.

From the outset of an investment, it is very difficult to be certain whether the SSE will be available or not and when this is compared to other territories that do provide certainty, (for example by way of quantitative acquisition cost test) it makes the UK an unattractive jurisdiction from which to hold investments. Although in a typical PE context it would be anticipated that a sale of a portfolio investment would satisfy the trading test it is not a clear cut exercise. A potential charge on a share disposal would be a material amount and so it is hard for the UK to compete if there is any doubt about whether the SSE will be available on exit. Some of the common areas of complexity faced typically concern whether a portfolio company is trading or not; ensuring the 12 month holding period is met (especially in syndication) and difficulties in determining whether "earn-outs" (where the difference between the present value of the earn-out at the time of disposal and the amount it ultimately produces) will be taxable.

### Hybrids mismatch regime and interest deductibility framework

As highlighted above one of the challenges is the UK's wide-ranging interest deductibility regime which is one of the hardest regimes to navigate and often produces mismatches. In particular the UK's implementation of the anti-hybrid rules and its approach to whether investors in a co-mingled fund 'act together' results in disallowance of interest cost because of unconnected and independent investors. As noted above an AHC needs to result in minimal additional corporate taxation in order to be tax neutral for most fund investors. A UK AHC which flows shareholder debt to portfolio companies could often generate additional corporate taxation. It is not possible to use a UK AHC with any confidence unless the fund manager can be confident that it would produce corporate level taxation commensurate with the activity and role of the AHC as is possible in other territories.

### UK withholding tax on interest

The withholding tax that the UK imposes on interest paid to non-residents makes the financing of UK companies more expensive. This is because it requires the borrower only to raise capital from qualifying lenders (i.e. lenders that can receive interest free from UK WHT), rather than the full spectrum of possible lenders. The syndicate of potential lenders for leveraged finance transactions includes CLO vehicles and other lenders that are not qualifying lenders. Although UK companies can raise finance in the form of listed bonds without this issue, private equity funds

also seek to raise financing through term loans, revolving credit facilities and unitranche debt all of which is difficult/impossible to raise in listed form.

The listing solution for shareholder debt used in straightforward private equity acquisition funding is not a panacea either. Obtaining the exemption for the payment of interest on a "Quoted Eurobond" ("QEE") is a cost and administrative hurdle that has little justification in terms of preservation of tax revenues or discouraging high risk transactions. Listing shareholder loan notes on a foreign exchange can be unattractive for a fund wishing to market itself as based entirely in the UK. A further point to note is that the definition of "qualifying lender" excludes many UK limited partnership structures, even if all of their investors are "good investors" (either UK corporates or entitled to treaty relief). Consequently, it makes lending from the fund into a UK AHC a costly exercise and an administrative hassle (if there is no ability to list the debt). Whilst the QEE remains a useful and frequently used exemption, a specific exemption from withholding on interest for a new AHC would be welcomed.

**Foreign exchange transactions**

The UK's rules relating to the taxation of foreign exchange gains and losses are complicated and again can produce taxation where economically there is no gain for the investor base. One example of this would be where a fund staggers its investment in a foreign company and a forex gain can arise between the time the investment is arranged and the time it is made. Given that a UK AHC will be exposed to currency fluctuations it is important that the AHC provides a mechanism with which it is possible to manage the risk.

The UK rules recognise exchange gains and losses as they accrue, rather than on a realisation basis adopted by some territories, like the US, who recognise them only on disposal of the asset or liability. In the Netherlands for example, a qualifying shareholding for the purposes of its participation exemption ensures that foreign exchange movements are fully exempt from corporation tax, just like capital gains and dividends.

**CFC regime**

The UK CFC rules need to be reviewed to ensure that a UK AHC is not unintentionally swept into the rules. As highlighted, maintaining tax neutrality through the AHC is a critical aspect needed to make the regime attractive. However, there can be no risk that that the AHC or its subsidiaries are deemed to reduce or eliminate UK tax under the CFC rules such that there is an attribution of profits.

**Taxation of upstreaming proceeds**

From a UK personal tax perspective, a key disadvantage of a UK resident company is the inability to receive amounts in respect of shares above the original subscription price, without this being treated as an income distribution for UK tax purposes The effect of this can be to turn capital into income for UK tax purposes.

- In the conventional Fund scenario, the "capital into income" aspect can occur in the following circumstances:
    a. Sale of one portfolio company while retaining others. In this instance there is a clear preference for, say a Luxembourg incorporated AHC.
    b. A partial IPO of a portfolio company held by a Holdco/Bidco structure – shares may be sold down to independent purchasers by the AHC over time with proceeds returned

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to investors in tranches over a similar period, clearly this is a capital type transaction but the repatriation of the sums is likely to be treated as a taxable distribution.

c. A Trade and Asset sale – where one investee portfolio company makes a trade & asset sale to a third party, for example to sell a particular "site" of a business held within the same entity but to retain the other "sites", and the onward repatriation of the cash.
d. Carve-out transaction where certain subsidiaries are sold, whether or not following an internal asset reorganisation.

Typically this will result in income tax treatment (38.1% dividend tax) in respect of a distribution made by an UK tax-resident company. There are very few exceptions and they are not helpful in an equity fund context.

The share buyback conditions under section 1033 CTA 2010 will be impossible to satisfy in an AHC context:

a. "purpose of benefitting a trade" requirement will be impossible to meet as an AHC is an investment company.
b. 5-year ownership requirement in ordinary situation.

The exempt demerger rules in section 1075 et seq CTA 2010 are subject to strict requirements and do not help with returns of cash.

By contrast, distributions by a non-UK resident company are only presumed taxable under income rules if the distribution is a dividend[1]. Subject to the transactions in securities rules, which one would not expect to apply where an AHC is returning in capital form an amount it initially received through a capital transaction, it is possible for returns of capital made by a non-UK resident company to give rise to capital treatment in the shareholders' hands. The treatment will typically turn on the local company law characterisation following *Rae v Lazard Investment Co Ltd* (1961-64) 41 TC 1 and *Baker v Archer Shee* [1927] UKHL 1.

## Which investors does this impact?

All investors are potentially affected by increased corporate tax leakage at an AHC level, which reduces the Internal Rate of Return of the Fund in question. As regards the personal taxation implications, many corporate investors in limited partnerships, resident in a variety of territories will be ambivalent between usual dividend treatment and a repatriation by share buyback or other return of capital. The same applies to tax-exempt investors.

However, UK non-corporate investors, such as individual investors and trusts will experience a material difference in personal taxation if, on the one hand (a) a disposal is undertaken directly by the fund, or an overseas-incorporated AHC undertakes a return of capital from a disposal, and (b) a UK AHC distributes the proceeds of a capital sale.

Another issue is the treatment of the fund's executives who manage the investments. The existence of a UK AHC would currently cause parts of the executives' taxable flows (both their carried interest and their returns from their coinvestment in the fund) on genuine third-party disposals to be taxed as income. A fund that uses a UK AHC under current law could find it harder to attract talented executives, as the executives would face higher taxation than if they were associated with managing a fund that does not use a UK AHC.

[1] Section 402 ITTOIA 2005

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

For private equity strategies, it is currently rare to use a UK AHC in the sense of a permanent investment holding vehicle – the personal and corporate tax disadvantages are too great as explained above.

We have highlighted how other countries address these challenges in our comments to Q4. In summary, jurisdictions like Luxembourg have introduced more pragmatic anti-hybrid rules, established and accepted transfer pricing methodologies, and an ability to return capital to investors in a way which is treated as capital in the UK. Overall, other territories have been able to provide a level of certainty around the expected tax position which is a very important aspect of the overall attractiveness of those jurisdictions. As a result there has been little incentive to use the UK and establish AHCs here.

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

There have been a number of recent developments in the international tax landscape that have ongoing implications for where AHCs are located.

Action 6 of the OECD BEPS agenda focused on the prevention of treaty abuse. The 2015 Final Report "Preventing the granting of treaty benefits in inappropriate circumstances" sets out a series of recommendations for addressing treaty abuse, in the form of changes to the OECD Treaty Model. Amongst these recommendations was the introduction of the Principal Purpose Test (PPT). The MLI, which modifies the application of bilateral tax treaties has meant many jurisdictions have supplemented their existing treaties with a PPT. The BEPS Action 6 requirements have added to the incentive to concentrate AHCs in countries where the asset manager already has "substance".

The recent decisions in the CJEU Danmark cases put the spotlight on Luxembourg holding structures. The cases concerned whether EU Directives providing withholding tax relief should apply and whether recipients of interest/dividends could be regarded as beneficial owners of the income. The judgements have placed tension on obtaining treaty relief where the ultimate parent entity is resident in a third country.

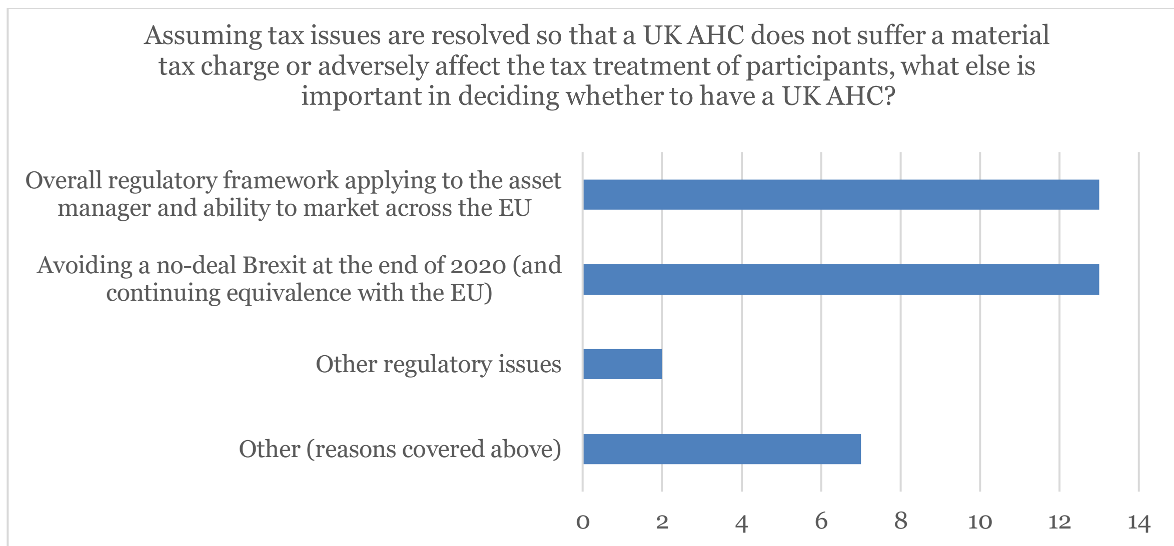
Increased "substance" requirements have also been put in place in Crown Dependencies and Overseas Territories by the OECD's global minimum standards to 'no or only nominal tax' jurisdictions. This has resulted in jurisdictions such as Cayman, Bermuda, Jersey and Guernsey introducing comprehensive economic "substance" legislation, under which in-scope entities that carry on particular activities are required to demonstrate economic "substance" from 1 January 2019,

Overall, this has meant that it is necessary to enhance substance levels in holding territories such as Luxembourg and others, where the holding territory is not the one in which the investment management activity is based, and often at higher costs. Amongst asset managers, there is a desire to consolidate that activity in a jurisdiction like the UK if there was a suitable regime available.

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

From an AHC perspective, in the sense of a long-term asset holding vehicle for multiple investments, the barriers to using the UK are principally tax ones. However, the desire to co-locate with an EU AIFM and AIF is a key non-tax barrier. As explained above, a number of firms have set up structures in the EU to continue to benefit from marketing passports available under the AIFMD and due to investor considerations. In light of Brexit, it might still be necessary to have some EU presence to access EU investors.

Out of a total of 21 respondents to our survey, avoiding a no-deal Brexit at the end of 2020 (and continuing equivalence with the EU) was of high importance, as was the regulatory framework applying to the asset manager and ability to market across the EU. Other factors considered important were political stability, including the stability of the tax regime, and the VAT treatment of investment management fees. Resourcing considerations were important, as was ensuring there is no regulatory burden at the level of the AHC as the regulatory regime is at the level of the manager.




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

Subject to a robust gateway provision (see further below in Q9), the following key attributes would be required to create a successful AHC regime in the UK:

- A broader corporate capital gains exemption similar to the Luxembourg Participation Exemption (i.e. no tax on gains from investment in companies not set up in tax haven if AHC's investment is (say) 10% or more of ordinary share capital or the acquisition cost is more than a specified amount)
- Confirmation that profits from investment transactions by an AHC will be treated as capital (like reg 80 of Offshore Funds (Tax) Regs 2009)).
- Finessing underlying corporation tax rules for qualifying AHC to provide a pragmatic approach to the UK anti-hybrid rules around acting together and exempt investors as well as reliable

guidance to apply transfer pricing rules that recognise the relatively modest returns that should be generated on the shareholder debt flows through the AHC.
- A withholding tax exemption on interest payments.
- Effective management of forex exposure on investment holdings in non-sterling currency such that no tax on forex gains relating to investments arises.
- Entitlement to capital treatment for UK investors on returns of capital amounts. This may need to be accompanied by modifications in company law to enable a more flexible range of means for returning capital.
- A clearance procedure to provide certainty around qualification and eliminate CFC risk.

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

### The design of a new AHC regime

We recognise HMT's concern noted at paragraph 1.12 of the AHC Consultation that the Government would not be prepared to make changes that take significant amounts out of charge to UK taxation or that would go materially against the grain of UK tax principles. A UK AHC regime would essentially be neutral. UK investors in a fund would be taxed on returns from the AHC which would reflect the AHC's investments in portfolio companies. Extending effective tax neutrality to a UK AHC is in reality just an extension of the UK's existing policy of (put broadly) not taxing investment fund vehicles.

As recognised in paragraph 4.9 of the AHC Consultation, robust entry criteria are required, such that once satisfied the AHC enters some form of ring-fenced tax regime. Whilst on the one hand it is key to have a secure entry system that cannot be abused, at the same time it should be free of quirks that could trip up funds relying on the treatment.

As recognised in paragraph 4.9 of the AHC Consultation, it is possible that a different set of rules could apply to each of private equity and credit funds once the entry criteria are met. Conceivably different entry criteria may be appropriate for each of these strategies; however one imagines that the essential characteristic of a widely marketed fund should be common to all and form the backbone of the entry criteria.

A fast and effective tax clearance system would be required to give managers the required certainty.

### Entry conditions – assessment of criteria

Our starting point to qualify for the regime is to say that if the AHC is owned by a fund, then the beneficial treatments would apply. The regime should include entry criteria that identify the key hallmarks of "funds". There would need to be a test of ownership by the fund, as AHCs may not necessarily be 100% owned or controlled. Holding companies used in other contexts, i.e. contexts outside the intent of the new regime would be excluded.

Selecting an appropriate "hallmark" of a fund is challenging. There is little by way of precise definition of funds in the regulatory or accounting sphere, most tests are supported by interpretative comment and expert judgment. We have included for ease of reference a number of the legislative tests referred to in Appendix 2.

The key concepts one may wish to include are:

- Generic fund features – obtaining capital from investors to invest in various investments – this may be found in the IFRS 10 definition of "Investment Entity" and the EU definition of Collective Investment Undertaking embedded in the UCITS and AIFM Directives.

- Lack of investor control – an important hallmark of usual limited partnership Funds. However, some small corporate investment structures may not have this feature – we would argue that this need not be satisfied if other conditions can be satisfied. This feature is found in the IFRS 10 and the section 235 FSMA definition[2]. This is also reflected in the ESMA interpretation of the definition of "AIF" in the AIFMD.

- Widely held – it is important to ensure that any beneficial treatments cannot be artificially accessed by related parties, family holdings and similar. Generally, the regulatory definitions are non-prescriptive apart from a requirement to have more than one investor (the definition of Investment Entity in IFRS 10 leaves the number of investors to judgement). Accordingly, a Genuine Diversity of Ownership is appropriate in our view.

## Rationale for the proposed approach

The proposed approach borrows a number of concepts from the regime for property rich investment vehicles in the recently introduced Schedule 5AAA TCGA 1992. However, some additional flexibility is being proposed to cater for the full breadth of private equity and other fund strategies' structures including holding companies used by non-conventional funds, joint investment vehicles and venture capital funds. To meet these aims, we have suggested 2 alternative "gateways" to the regime.

## Outline of the legislative approach

"Fund" means a body corporate or a partnership which satisfies any of the following: -

- It is an AIF for the purposes of Regulation 3 of the AIFMD
- It is a "Collective Investment Scheme" under section 235 FSMA or an Investment Trust[3], or
- It is an Investment Entity for the purposes of IFRS 10 and thus does not consolidate the results of its investments.

"Qualifying AHC" means a company which satisfies the requirements in Qualifying AHC Gateway 1 or Qualifying AHC Gateway 2.

"Company" takes its meaning from section 1121(1) CTA 2010[4].

Qualifying AHC Gateway 1 – Institutional Funds

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[2] See Appendix 2

[3] See approach in s. 809EZA(6) ITA 2007 in the Disguised Investment Management Fee rules

[4] Definition of "Company" and "Holding Company" will be needed. In the Corporation Tax Acts this means 'any body corporate or unincorporated association, but does not include a partnership, a co-ownership scheme as defined by FSMA00/S235A, a local authority or a local authority association'.

- If Conditions A,B and C are met, then any holding company which is "majority held" by a Fund shall be regarded as a "Qualifying AHC"
    - Condition A – the Fund is managed or advised, directly or indirectly by a regulated (not necessarily in the UK) investment adviser or manager; and
    - Condition B – the Genuine Diversity of Ownership test is met by the fund or the AHC meets the "non-close" test
    - Condition C – The company makes investments in more than one qualifying investment.

Qualifying AHC Gateway 2 – AHCs jointly held by Funds, direct investors and joint ventures

- If Conditions A, B,C and D are met by a company, then the company shall be regarded as a "Qualifying AHC"
    - Condition A – The company is not directly or indirectly "majority held" by a Fund
    - Condition B – A Fund[5] holds a "material interest" in the company; and
    - Condition C – the "non-close" test is met in respect of the company
    - Condition D – The company makes investments in more than one qualifying investment.

AHC Reliefs

- A Qualifying AHC shall be entitled to the following "AHC Reliefs" in respect of the company concerned, and its shareholders as relevant:-

    - Disapplication of income tax on non-dividend distributions made by UK AHCs (section 383 ITTOIA 2005) to the extent these exceed the original amount subscribed and proceeds come from underlying capital transaction (i.e. not from income received by the AHC)
    - Disapplication of Transactions in Securities on capital distributions where the securities in question are securities issued by a Qualifying AHC
    - New Participation Exemption overriding SSE for disposals of shares or securities in other companies (or assets which derive their value from such shares or securities) made by a Qualifying AHC with objective criteria focused on acquisition cost
    - All investment transactions by a Qualifying AHC treated as capital
    - The Qualifying AHC would be taxed under normal corporation tax principles with detailed and reliable transfer pricing guidance to result in a relatively modest return generated by the shareholder debt routed through a Qualifying AHC
    - Revisions to the UK Anti-Hybrid rules so that independent passive investors are not viewed as "acting together"
    - A gain/loss purely deriving from forex movement on assets or liabilities held by the AHC shall be excluded from the tax computation
    - No withholding tax on interest payments. (If an alternative to the QEE from interest withholding tax is provided it should not have significant conditions attached (otherwise the QEE might be retained as a lesser of evils)
    - CFC legislation will not impose a tax charge on Qualifying AHC
    - Retention of the dividend withholding tax exemption.

[5] In this context, it is noted that a nominee arrangement, an investment club or an EIS fund are generally expected to qualify as an AIF

Meaning of "majority held" with respect to Qualifying AHC

- The AHC in question is controlled (s1124 CTA 2010) by the Fund.

Meaning of "material interest" with respect to Qualifying AHC

- The holding in question represents 25% of the ordinary share capital of the company and there is involvement in management of the AHC by the Fund (see "scheme director condition" in the income-based carried interest rules of Part 13 ITA 2007).

Genuine Diversity of Ownership test[6]

- The Fund meets the genuine diversity of ownership condition at any time if, were it an offshore fund, it would—
  (a) meet the conditions in regulation 75(2), (3), and (4) of the Offshore Funds (Tax) Regulations 2009, or
  (b) meet the condition in regulation 75(5) of those Regulations,

Non-close test

- To incorporate by reference the test in paragraph 46(2) of Schedule 5AAA TCGA 1992 which seems generally appropriate in context – this has the advantage of:-
  - Incorporating the pre-existing detailed close company regime
  - disregarding the control powers of investment managers and general partners
  - powers not to be attributed to a person purely by virtue of being a partner

Tax Clearance procedure

- An application may be made on behalf of a company for HMRC confirmation that it qualifies as a Qualifying AHC or to resolve any areas of difficulty.

The UK needs to work quickly to make the UK AHC regime an attractive proposition in order that managers can and do set up their AHC here in the UK. For a UK fund manager, the Principal Purpose Test brings the AHC jurisdiction into sharp focus and managers who are about to raise a fund need certainty on how to navigate this and other issues. The government needs to press ahead with this initiative swiftly; fund managers are deciding all the time where to locate their next fund or AHC. The more these are located offshore the harder it will be to reverse individual decisions or resist the pull of market practice. We would also urge the government to continue its open dialogue with industry (affected firms, trade bodies and advisers) so that any UK AHC regime introduced meets industry's needs and is attractive and in consequence successful.

We would be grateful for an opportunity to meet and discuss the feedback provided in this letter.

Please let us know if you have any comments or questions in the meanwhile.

[6] Importing the same test of GDO in paragraph 13 of Schedule 5AAA TCGA 1992 relating to Property Rich Collective Investment Vehicles

Yours faithfully,

Mark Baldwin
Chairman of the BVCA Taxation Committee

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## Appendix 1 – Case Studies

We have included below a number of case studies which illustrates some of the challenges encountered by managers of private equity and similar strategies in using UK AHCs under the current tax legal framework.

The first case study concerns the position of a typical large private equity fund, which has chosen to use a UK company as an AHC, for investment in several jurisdictions.

Other case studies illustrate some less obvious situations where the current UK tax law would deter use of a UK tax resident company as an AHC sitting under a fund limited partnership. Alternatively, where UK tax resident companies are used at any point in the structure, how UK personal tax rules operate can convert capital-type realisations into distributions taxed at income tax rates for non-corporate participants in the investment.

### Case Study 1 – AHC under large Institutional limited partnership funds sells one of its investments

a. Fund limited partnership is established in the UK, managed by a UK-established General Partner
b. To assist with obtaining access to Treaty relief without excessive enquiry into the identity of investors, investments are held by an AHC
c. Assume that AHC is incorporated and tax-resident in the UK
d. The repatriation of the proceeds of sale of one investment, without liquidation of the entire entity would typically be taxed as dividend income.

This lowers the attractiveness of the Fund to certain classes of investors, and hampers attracting executives who could work at other PE houses with lower personal tax implications.

### Case Study 2 – AHC realises part of shares by IPO

a. AHC holds investee trading company
b. After any required share class reorganisation, the AHC sells a proportion of the shares in an IPO. The AHC receives the floatation proceeds
c. The AHC then seeks to repatriate proceeds to the Fund/Investors. Except to the extent of repayment of the original cost of shares in the AHC, this will be treated as an income distribution.

### Case Study 3 – divestment of unprofitable division

a. AHC holds Trading Company A, which has since diversified its customer offering and has in turn formed a subsidiary Company B specialising in other activities. However since then Company B's results have faltered. It is no longer considered a productive use of Management's time to focus on managing Company B
b. Accordingly it is desired for Company A to sell Company B. Although it will be sold at a modest value, it exceeds the original cost as funded by shareholder subscription to the AHC and the AHC's loan funding of Company A for the acquisition
c. Following sale of Company B, the proceeds are distributed by Company A by means of repayment of Company A's funding loan and share repurchase, and the AHC plans to return capital to the Fund and/or investors by means of a share buyback at a premium to the original acquisition cost (funding to be arranged in accordance with Company Law)

d. The premium would be taxed as income under current law, despite the source of the monies being a capital transaction

**Case Study 4 – Corporate fund – multiple investments**

a. A team of PE executives establishes new investment firm
b. To attract institutional investors it will need to show a track record of deals within the new team
c. Typically the new investment firm will undertake deals in separate UK holding companies
d. However investors may wish to participate
e. Further, the team may not wish to incur the cost in setting up a fund entity – such cost can be disproportionate to an emerging fund manager
f. Investors in some territories are used to participating in several investments via one company and still getting capital treatment
g. Investors may still have significant levels of control over management of the investments due to the conditions necessary to attract their investment
h. The difficulty comes when one investment but not all of them will be sold
i. The strategy may be to wait until the last investment has been sold – but this is unattractive to investors
j. The main adverse impact is income treatment for the PE executives – they are given worse tax treatment than had they established a fund as a limited partnership
k. Any redistribution of dividends by a subsidiary will be treated as a distribution

**Appendix 2 - Statutory "Hallmarks" of Alternative Funds**

## The Alternative Investment Fund Managers Regulations 2013 No. 1773

**Meaning of "AIF" (largely tracks the AIFM Directive definition)**

3.—(1) "AIF" means a collective investment undertaking, including investment compartments of such an 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.

(2) An AIF may be open-ended or closed-ended, and constituted in any legal form, including under a contract, by means of a trust or under statute.

(3) None of the following entities is an AIF—

(a) an institution for occupational retirement provision which falls within the scope of Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision;

(b) a holding company;

(c) an employee participation scheme or employee savings scheme;

(d) a securitisation special purpose entity.

N.B. *The term "collective investment undertaking" is not defined either in the Directive or under European law, and is per se a very broad concept. ESMA has specified that one of the characteristics of a collective investment undertaking is that it "pools together capital raised from investors for the purpose of investment with a view to generating a pooled return for those investors"*

## Financial Services and Markets Act 2000

**235.— Collective investment schemes**

(1) In this Part "collective investment scheme" means 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.

(2) The arrangements must be such that the persons who are to participate ("participants") 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.

(3) The arrangements must also have either or both of the following characteristics–

(a) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled;

(b) the property is managed as a whole by or on behalf of the operator of the scheme.

(4) If arrangements provide for such pooling as is mentioned in subsection (3)(a) in relation to separate parts of the property, the arrangements are not to be regarded as constituting a single collective investment scheme unless the participants are entitled to exchange rights in one part for rights in another.

(5) The Treasury may by order provide that arrangements do not amount to a collective investment scheme–

(a) in specified circumstances; or
(b) if the arrangements fall within a specified category of arrangement.

## IFRS 10

IFRS 10 states that an investment entity shall not consolidate its subsidiaries or apply IFRS 3 when it obtains control of another entity. Instead, an investment entity shall measure an investment in a subsidiary at fair value through profit or loss in accordance with IFRS 9.
[…Paragraphs 27 and 28 of IFRS 10 are extracted below…]

27. A parent shall determine whether it is an investment entity. An investment entity is an entity that:

a. obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services;
b. commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both; and
c. measures and evaluates the performance of substantially all of its investments on a fair value basis.

28. In assessing whether it meets the definition described in paragraph 27, an entity shall consider whether it has the following typical characteristics of an investment entity:

a. it has more than one investment;
b. it has more than one investor;
c. it has investors that are not related parties of the entity; and
d. it has ownership interests in the form of equity or similar interests.

## Genuine Diversity of Ownership test used in Schedule 5AAA TCGA 1992

**Paragraph 46(4) of Schedule 5AAA TCGA 1992**

(4) For the purposes of sub-paragraph (3)(*a*) a collective investment vehicle meets the genuine diversity of ownership condition at any time if, at that time—

(*a*) it meets [the conditions in regulation 75(2), (3) and (4)(*a*)][2] of the Offshore Funds (Tax) Regulations 2009, or

(*b*) it meets the condition in regulation 75(5) of those Regulations [(assuming for this purpose that regulation 75(4)(*b*) is omitted)][2],

and those Regulations apply for the purposes of this sub-paragraph as if any collective investment vehicle which is not an offshore fund were regarded as an offshore fund [(and see also paragraphs 46A and 51)][2].

**Offshore Funds (Tax) Regulations 2009 (SI 2009/3001)**

**75 The genuine diversity of ownership condition**

(1) The genuine diversity of ownership condition is met if the fund meets [, or, in relation to a fund constituted by a class of interests in the main arrangements, the main arrangements meet,] conditions A to C throughout the period of account.

(2) Condition A is that the fund produces documents, available to investors and to HMRC, which contain—

(a) a statement specifying the intended categories of investor,

(b) an undertaking that interests in the fund will be widely available, and

(c) an undertaking that interests in the fund will be marketed and made available in accordance with the requirements of paragraph (4)(a).

(3) Condition B is—

(a) that the specification of the intended categories of investor do not have a limiting or deterrent effect, and

(b) that any other terms or conditions governing participation in the fund do not have a limiting or deterrent effect.

(4) Condition C is—

(a) that interests in the fund must be marketed and made available—

(i) sufficiently widely to reach the intended categories of investors, and

(ii) in a manner appropriate to attract those categories of investors, and

(b) that a person who falls within one of the intended categories of investors can, upon request to the manager of this fund, obtain information about the fund and acquire units in it.

[(5) A fund also meets the genuine diversity of ownership condition if—

(a) an investor in the fund is an offshore fund, an open-ended investment company or an authorised unit trust scheme ("the feeder fund"),

(b) conditions A to C are met in relation to the fund after taking into account—

(i) the fund documents relating to the feeder fund, and

(ii) the intended investors in the feeder fund, and

(c) the fund and the feeder fund have the same manager (or proposed manager).]

**76 The genuine diversity of ownership condition: further provisions**

(1) For the purposes of regulation 75(3) a limiting or deterring effect means an effect which—

(a) limits investors to a limited number of specific persons or specific groups of connected persons, or

(b) deters a reasonable investor falling within one of the intended categories of investor from investing in the fund.

(2) Condition C (see regulation 75(4) shall be treated as being met even if at the relevant time the fund has no capacity to receive additional investments, unless—

(a) the capacity of the fund to receive investments in it is fixed by the fund documents (or otherwise), and

(b) a pre-determined number of specific persons or specific groups of connected persons make investments in the fund which collectively exhausts all, or substantially all, of that capacity.

(3) For the purposes of this regulation—

(a) sections 993 and 994 of ITA 2007 (connected persons) apply in the case of a person chargeable to income tax, and

(b) section 839 of ICTA (connected persons) applies in the case of a person chargeable to corporation tax

## The Non-resident CGT "non-close" test

**Paragraph 46(2) of Schedule 5AAA TCGA 1992**

**46**

(2) Whether a company is "a close company" is determined in accordance with the rules in Chapter 2 of Part 10 of CTA 2010 but subject to the following modifications—

(*a*) section 442(*a*) (non-UK resident companies) is to be treated as omitted,

(*b*) section 444 (companies involved with non-close companies) is to be treated as omitted,

(*c*) section 447(1)(*a*) (shares in quoted companies beneficially held by non-close companies) is to be treated as omitted, …[2]

(*d*) for the purposes of any attribution under section 451(4) (rights of a person's associates to be attributed to the person etc in determining "control") the rights and powers of a person ("A") are not to be attributed to another person ("P") merely because A is a partner of P[, and

(*e*) a company ("C") is not to be regarded as a close company only because a person possesses or is entitled to acquire the greater part of the voting power in C as a result of being—

(i) a manager of a collective investment vehicle, or

(ii) a general partner in a limited partnership which is a collective investment scheme.][2]