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

23 February 2021

Dear Sirs,

Re: BVCA response to the Tax Treatment of Asset Holding Companies in Alternative Fund Structures (Government response and second stage consultation)

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 ("PE/VC") industry in the UK. With a membership of over 700 firms, we represent the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers and investors. Between 2015 and 2019, BVCA members invested over £43bn into nearly 3,230 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by private equity and venture capital currently employ 972,000 people in the UK and the majority of the businesses our members invest in are small and medium-sized businesses.

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". We welcome the second stage of 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 that is being undertaken[1].

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.

Before addressing the questions in the consultation paper in detail, we would like to make what we believe is a key, overarching point: for the UK AHC regime to be successful (which we all hope

[1] HMT Review of the UK funds regime: a call for input

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very much that it will be) it is absolutely crucial that the regime can "beat the opposition into the ground".

Fund managers with AHC platforms in another jurisdiction will not go to the time and trouble of moving back to the UK (which could involve making valued colleagues in other jurisdictions redundant) unless the UK AHC regime is better than the existing regime. Other managers looking for an AHC regime will not choose the UK unless the UK AHC regime is at least as good as the alternatives. Clearly, a very important part of that comparison is the ability to co-locate functions in the UK with all the cost and other benefits that brings. But that of itself will not be enough; if it were, no UK manager would use a non-UK AHC at the moment.

The UK AHC regime must measure up to the opposition. In reality, certainly in the PE/VC space, there is only one serious competitor jurisdiction and that is Luxembourg. The Luxembourg AHC regime is attractive because it is simple and does not create tax cost. It uses existing corporate tax regimes and so there is no "entry test" before the regime can be used. Equity returns (dividends and capital proceeds) benefit from a straightforward and clear participation exemption. Other profits (shareholder debt yield) are taxed on a margin basis, which produces an appropriate tax cost bearing in mind the AHCs functions. Proceeds can be returned to investors without any withholding or other Luxembourg tax costs for investors.

We appreciate that the UK and Luxembourg are very different. No one invests in Luxembourg; there is nothing there. But funds do invest in the UK. There are Luxembourg-based fund investors, but they are not investing for the local population; it is too small. But funds do invest for UK residents. Clearly, against that background the UK government will have concerns that the Luxembourg government does not.

Nevertheless, in a competition to provide an investment structure for global capital, taking investment from around the world and deploying it to multiple jurisdictions, a regime which is designed to address every conceivable local issue will sink under the weight of its own complexity.

It is also important to see these concerns in context. There is very limited use of UK companies to hold non-UK investments, especially in a fund context. There is no current UK tax to be lost, because funds and investments that might be routed through UK AHCs are not here at the moment. This is a proposal which can only be a gain for the Treasury.

The need to avoid complexity and uncertainty is a really important point; no one will dare to use a UK AHC regime if they cannot be sure (as they can be in Luxembourg) that its perceived benefits will be available to them and (more importantly) their investors. A complex and uncertain regime will rapidly become a white elephant.

A simple entry requirement (restricting the UK AHC regime to appropriate, low-risk users) is the way to reconcile understandable domestic concerns with the need to offer a regime which is attractive to users providing services to global capital.

So, to be successful, the UK AHC needs to:

- have clear entry criteria. We suggest a minimum percentage ownership by funds which meet a diversity of ownership (or "GDO") test or other qualifying investors;
- allow other investors (joint venture partners from outside the funds space) to participate in the AHC subject to the entry test still being met;

- offer a broad "participation exemption" for dividends and capital returns on equity;
- tax other profits (principally, yield on shareholder debt) on a margin basis that reflects the AHC's role;
- tax UK resident investors in the same way as they would be taxed if they participated in the "opposition" (a Luxembourg partnership with a Luxembourg AHC);
- be as straightforward to operate as possible; and
- avoid creating unnecessary risk of failure.

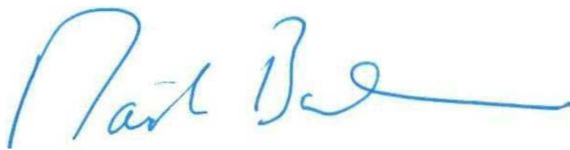
We should stress that we greatly appreciate the time and commitment of HMT HMRC in this process so far and their willingness to listen and engage has been very encouraging. It would be a great shame if all this went to waste.

As this process develops, continuing this approach will be important and we would urge further discussions and the early sharing of draft legislation with interested groups before it is formally issued. In addition, as we are confident HMT and HMRC are aware, a new regime such as this will require suitably skilled and experienced personnel within HMRC; this will be crucial going forward and, once again, relates to the comparison with Luxembourg, where dealing with the tax authorities is regarded as straightforward. HMRC must be resourced to offer similar ease to users of the new UK AHC.

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.

Yours faithfully,



Mark Baldwin
Chairman of the BVCA Taxation Committee

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Detailed feedback on consultation questions

Question 1: Do you think an AHC regime should include arrangements where some or all of the investors invest directly at the level of the AHC as discussed in paragraph 4.25?

We are firmly of the view that the eligibility criteria should allow for the possibility of such arrangements.

This is extremely common in all types of fund structures where certain investors or external parties hold their interests via their own vehicles or directly rather than through the core fund vehicle. In passing, any definition of "fund" should include vehicles investing in parallel which make up a single "fund"; the definition of an "associated" investment scheme in s809FZZ ITA 2007 may be helpful here. In larger funds there may be bespoke arrangements for certain investors or additional co-investment with an investor alongside the fund. Equally, it may occur with smaller funds which rely on a degree of external funding from a family trust or high net worth individual. In addition, there may well be cases in which the interest in the AHC may be partially purchased by an external party so that the fund interest is reduced.

There must also be the possibility of external (non-fund) investors participating in the AHC (eg if an industry joint venture partner co-invests alongside a fund). In large transactions, an investment may be made by more than one fund jointly, so the regime should also allow more than one fund to hold interests in a UK AHC.

We appreciate that this is a fund AHC regime and so a minimum level of participation in the AHC by one or more "funds" will be required.

Certain types of investor (eg insurance companies, charities/endowments, pension schemes and sovereign wealth funds) effectively operate like funds and their participation should count as a participation by a fund. A starting point might be the approach in the substantial shareholdings exemption regime (para 30A, Schedule 7AC TCGA 1992) or the non-resident CGT regime (para 46(3), Schedule 5AAA, TCGA 1992).

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

In many instances investors participate directly or through their own vehicles to allow for variations in the legal and economic arrangements. For example, there could be differences in the management fee arrangements or a vehicle could be set up which provides for different carried interest entitlements. Investors from certain jurisdictions may require different legal arrangements to accommodate their own laws.

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

Provided there is a minimum level of ownership of an AHC by funds which meets a genuine diversity of ownership ("GDO") requirement or by equivalent entities (see above), we do not

consider accommodating these types of direct investment arrangements would result in a risk of abuse or avoidance.

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

The question does not make it clear why the investors are being identified and we are not sure that they need to be. If the idea is that an AHC is one which is owned to a significant degree by funds which meet a GDO requirement or other permitted investors, we do not think that it is necessary to look behind those funds or investors. If there is to be a required level of ownership by qualifying funds/investors then clearly there needs to be a way of measuring that. Any method of measuring ownership should be simple and clear. If the focus is on economic ownership, a modified version of the "equity holder" concept in the group relief rules may be closer to what you have in mind than "participator" in the close company regime. We would prefer a simpler test such as control in s1124 CTA 2010, where a company can be an AHC as long as qualifying investors (taken together) have s1124 control of it or if the AHC is a "deadlocked joint venture" between one or more qualifying funds (on the one hand) and a single joint venture partner (on the other) .

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

The new rules should accommodate tiers of AHC with maximum ease and efficiency. Ownership should be subject to similar criteria as the "top" AHC so that, if the threshold for widely held ownership is 25%, then companies within a 25% diverse ownership traced down the structure should also be eligible. If s1124 control were the test, this could easily be tested at different levels. Another approach might be to say that a company which is controlled (using the s1124 test) by an AHC can itself be an AHC.

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

If we are looking at who operates/advises a fund (in order to meet a GDO test), this should be clear in most if not all cases. It should be sufficient to refer to a person who provides portfolio management services.

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

Under UK company law, it is the directors of the company who are responsible for managing its business. It may be possible for directors to delegate tasks to others, but we should be careful about imposing a management requirement for an AHC which puts strain on the directors' ability to discharge their company law duties. In addition, the fund manager will typically advise or operate the fund, rather than its investors. We have made the point above that certain investors (where there would not normally be an external manager) should be qualifying investors for these purposes. In terms of qualifying funds a requirement that investors should not have day to day

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control over investment management in order to satisfy a GDO test should meet your concerns. As we explain below, we do not believe that it would be helpful (or necessary) to go further and cap managers' interests in the AHC.

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

Generally, co-investment in a fund by the management team is no more than 3% but this can be considerably higher in the case of new funds, which need to attract investment. Larger co-investment may then be a condition of obtaining investment at all. We would counsel against imposing an arbitrary cap on managers' participation in the fund or AHC. Again, we consider the GDO requirement at fund level should naturally resolve any potential issues on management interests.

If you do impose a cap here, carried interest (which is now defined in the legislation) should not count towards it.

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

We would strongly urge that no such regime rules are included. The use of AHCs will always involve a variety of considerations and motives and we fail to see how tests relating to this would operate so as to protect the exchequer. We do not think that an AHC should be entirely "tax exempt" so that, if a trading activity were carried out, then the company would be taxable on the profits relating to this in any event.

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

As a general rule, we would expect AHCs to restrict their activities to investment. It is possible (particularly as this would help to demonstrate substance) that they might provide management services to portfolio companies. If they charged for those services, that would amount to a trade. Profit from such activities should be taxable but there should be flexibility for AHCs to do this.

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

The criteria in paragraph 4.49 run counter to our essential position that, for the regime to be attractive, it must be flexible once the conditions of entry are satisfied. The criteria in 4.49 may also discriminate against certain smaller funds which may not be able to raise a minimum amount of capital.

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

We do not fully understand why this would be considered abusive. It is not uncommon for there to be an agreement among investors for special participation in a subset of investments. Most obviously, investors may ask to be excused from certain types of investment a fund makes; examples are alcohol, gambling, tobacco, armaments and pork but there will be others too. Once

again, we do not think that the qualifying test for an AHC should look beyond the GDO condition and this should serve to provide a natural defence to private arrangements which might be prejudicial to certain investors.

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

As stated, except in specific cases involving certain categories of exempt investor such as sovereign wealth funds, we consider any provisions which go beyond the proper identification of a fund and GDO to be unnecessarily restrictive. Additional requirements are likely to render the regime less attractive than competitor regimes.

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

We consider it to be important that the approach to eligibility can encompass all types of fund.

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

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

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

We agree with the Government's approach which only seeks to tax an AHC commensurate with its level of activities. This is in line with the position in Luxembourg and to that extent the Government's approach is neutral.

In order to make the AHC attractive to all classes of asset manager we would recommend allowing deductions for costs on payments to investors which would otherwise be denied particularly in circumstances where they would treated as if they were a dividend. For example results-dependent instruments are commonly, but not exclusively, adopted in the distressed debt market. We would, however, recommend a general rule to this effect and not one linked to a particular type of instrument.

A requirement for tax deductibility to be linked to the availability of a capital gains exemption does not appear necessary because the principle running through the regime is that the AHC is only taxed to income on commensurate with its activities on a transfer priced basis. Any additional tax charge would make the regime uncompetitive as against the position in Luxembourg.

An inability to group relieve deductions outside of the AHC group would be unwelcome and could put an AHC in a worse position than an ordinary UK taxpaying company. We see no reason why costs which would give rise to surrenderable losses under normal corporation tax principles should not be capable of being relieved under the usual group relief regime to non-AHC group companies. Such a rule would therefore allow a wider adoption of AHCs. We can see that an ability to elect out of the "margin" basis of taxation for income other than dividends (but not the capital gains exemption and the ordinary dividend exemption) to permit group relieving losses may be an attractive solution.

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

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

In order to be internationally competitive, we would favour the deductions available to AHCs on payments to investors to be limited by the existing transfer pricing regime. It would be a considerable disincentive to the adoption of AHCs should the rules governing the restriction exceed the limitations that would arise under the transfer pricing regime or, perhaps more importantly, should they create any uncertainty as to whether such an outcome would arise.

In this respect the UK is competing internationally with well settled and well understood rules and the UK rules must therefore also be free from complexity and uncertainty.

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

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

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

Asset managers in considering the appropriate holding structure adopt the maxim that the structure cannot give rise to additional taxation than a direct investment in the investment asset in question. However, for regulatory, legal and commercial reasons a direct investment is not ordinarily possible. A holding structure must therefore be adopted.

If AHCs are to be adopted it must be the case that they do not give rise to taxation on capital gains. This should be the case irrespective of whether the disposal proceeds are returned to investors or are invested in further investment assets.

We agree that the AHC capital gain exemption should be instead of the availability of the SSE. But we would also note that it should be far simpler than the SSE and could be as simple as a full exemption for gains made by AHCs without giving rise to any Exchequer risks or boundary issues.

A substantial level of investment by a diversely-owned fund or other qualifying investors should be a sufficient safeguard that an AHC will not be used to "hoard" cash. Investors will not want to see cash "lying around" and not being used and most fund managers' performance (and rewards) are measured by reference to the IRR they deliver to investors.

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

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

We note the comment we make above in relation to the importance of tax neutral holding structures which applies equally to withholding tax. The Quoted Eurobond exemption is a well understood exemption which gives rise to modest administrative burdens and costs. We would welcome an AHC specific exemption from withholding tax but would note that if it was more complex, or gave rise to more uncertainty, than the Quoted Eurobond exemption (which it would do if it was limited to interest payable to investors in certain jurisdictions only) it would put the AHC regime at a serious competitive disadvantage internationally.

We would only be in favour of an AHC specific exemption if it was simple to apply and did not give rise to any administrative or other costs. We cannot see any reason to preclude AHCs from accessing the Quoted Eurobond exemption should they wish to.

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

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

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

A. Goals

We have addressed these questions together because we consider that the starting point for the tax treatment of investors should be based on the nature of the returns of the instruments they hold in the AHC (subject to certain modifications) and not through complex income/capital tracking rules which would create a significant barrier to entry into the AHC regime.

As we have noted earlier in our submission, simplicity needs to be the overarching goal of the AHC if it is to be a competitive regime which will: 1. retain and attract individual asset managers to the UK; 2. cater for the expanding group of smaller/mid-sized UK asset managers who are increasingly making investments in non UK-jurisdictions and contemplating where their investment platforms should be based; and 3. attract global multi-asset managers to re-locate to or establish significant platform or UK holding company offerings in the UK.

B. **Investor requirements**

1. All

All investors will be focused on any potential increased tax leakage or inefficiency at the level of the AHC. Many significant investors (corporates both UK and non-UK as well as all tax-exempt investors) will be, for the most part, less focused on the nature of the return they receive from an AHC i.e. dividend or a gain which is capital in nature. However, it will be essential to investors for investment returns to be repatriated through and out of the structure with minimal friction.

Further consideration will be required to ensure that the distributable reserves position of any AHC is manageable in order to provide investors with certainty that there will be no unforeseen hurdles to repatriating cash

2. UK taxpaying individuals

In this section we focus our response on the treatment of an individual UK investor as opposed to UK trusts/trustees. Many in this investor group will be UK based private equity executives (whether currently in role or those looking to move to the UK in the future, particularly, if the AHC regime achieves its commercial objectives) but there will also be external UK taxpaying individual investors in funds and portfolio company management team members may also invest in shares in a parent AHC**.**

(a) The required tax changes

The key issue to address is the operation of the UK tax rules which essentially convert capital into income on the distribution of proceeds from a capital sale to the extent the amount distributed is above the original subscription price for a share.

Many private equity asset managers deciding where to locate holding company structures may be impacted by this tax inflexibility given UK individuals will be taxed at 38.1% as opposed to 28/20% on what is the substantial proportion of their return generated by the realisation of underlying investments. This concern relates to both carried interest and co-invest.

When a UK holding company directly under the fund holds just one investment as opposed to being used as a platform holding multiple investments, a capital return for tax purposes can be achieved either by way of a liquidation distribution or, more commonly, a direct share sale. If an AHC is used as a platform then neither of these methods of returning capital for UK tax purposes is practically available.

The key instruments which could to be used to fund the AHC include shareholder debt, preference shares and ordinary shares. It is ordinary shares which present the main issue in terms of structuring returns from a tax perspective. From a mechanical perspective there are two main options which our proposed tax amendments should apply to in the private equity market: share buy-backs and returns of value following a reduction of capital (but see also below in relation to certain credit strategies).

(b) Our proposal

As previously stated our starting point is that the taxation of all investors in the AHC should be based on the economic returns of the instruments each holds without having to create a complex

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regime requiring the tracking of income and gains throughout what can be multi layered structures with cross border elements. This approach closely mirrors that of similar regimes in other jurisdictions, however in order to deal with the issue at B.2(a) a specific change to the UK tax regime will be required to the extent the eligibility criteria for an AHC have been satisfied.

We would disapply the income tax treatment for UK individuals at section 383 ITTOIA on non-dividend distributions made by UK AHCs on ordinary share capital. The individual would then receive an entirely capital return for tax purposes (as opposed to any element of distribution). Assuming the AHC only has one class of ordinary share in issue, individual investors would calculate their gain on the usual basis, a part disposal until the last return of capital.

(c) Ensuring simplicity

We consider that a material amount of the complexity in the Consultation stems from concerns around converting income to capital and the consequential erosion of the UK tax base. This concern should not be a driving force creating complex income/gain tracking rules which will hamper the AHC's attractiveness. The eligibility criteria will be sufficient to combat the risk of abuse.

First to reiterate most large LP investors will not see their UK tax bill increase or decrease purely as a result of the nature of the return from the AHC.

Secondly, comparing other regimes/structures in use, the extent of potential UK tax erosion in relation to UK individuals is limited. The most common structures utilised in terms of asset holding vehicles for funds with UK/European investment strategies are as follows:

1. A Luxembourg holding company as a platform with a number of investments (including in the UK): whether considering carry, co-invest or just a limited partner interest held by a UK individual – the tax treatment of the returns from this vehicle is dependent on the treatment of the instruments held in the Luxembourg entity. From a UK taxpayer's perspective the return on standard shareholder debt and preferred equity certificates (PECs) is invariably a mix of capital plus interest with various classes of ordinary equity allowing for partial liquidations delivering a capital return tracking returns repatriated up the structure (whether originally having an income or capital nature by UK tax standards). This regime also affords certain UK tax resident non-domiciles the ability to maintain a remittance basis of taxation due to the existence of the Luxembourg entity (coupled with a non-UK fund vehicle).

2. A siloed approach with no platform with each investment having a separate holding vehicle potentially in Luxembourg (see treatment above) or in the jurisdiction where the trading operations of the investment/its management is located. If a UK holding company is used then the investors may use a mix of shareholder debt, preference shares and ordinary shares to invest. To the extent there is a repayment of shareholder debt a UK taxpayer will receive capital and interest as normal (similar to 1. in relation to debt and PECs). To the extent a return is received on the preference shares then a dividend may be declared and taxed as income or there may be a redemption of the preference shares with the distribution element taxed as income. Given the return required by investors during the life of the investment, it is unusual that dividends would be declared on the ordinary shares before an exit event (which is invariably structured as a capital disposal).

3. If anything in a UK context as described in 2. (particularly where there is not just a full exit) we would say that the issue is more likely to be that what are capital transactions/events from an economic and commercial perspective (e.g. a carve out of a subsidiary or a trade and asset sale) are potentially converted in part or whole into income returns due to an inflexibility to return amounts to UK taxpayers in a capital form on amounts in excess of the subscription price.

From the above, we can see a potential for UK tax erosion where there is a roll up of tax free dividends paid through the structure which are then repatriated by way of either a share buy back/capital distribution in relation to ordinary shares (both treated as capital under our proposal). In summary, we would make the following points:

1. A Luxembourg holding vehicle comparable to an AHC would be able to return this as capital and in UK holding company siloed structures the value of ordinary shares is invariably realised by a capital disposal;

2. The UK tax rate differential is 20/28% versus 38.1% if what "should" be distributions on ordinary shares were converted to capital;

3. We would also note that from an executive's position there are also several other rules and regimes which make it difficult to manipulate returns: employment related securities, DIMF, carry rules, income-based carry rules;

4. Given all these points (and the fundamental safeguard that there must be an appropriate level of ownership by qualifying investors before a company is treated as an AHC) we do not perceive a significant risk of a material level of what should be an income return being converted into capital. If some safeguard is required, a very specifically targeted TAAR (or tightly drawn modification of the transactions in securities rules) looking just at the position of UK resident individual investors should suffice and this would be much easier for fund managers to work with than a detailed regime requiring income and gains within the structure to be tracked.

We also need to consider the position of remittance basis users ("RBUs"). These are individuals who are not domiciled or deemed domiciled in the UK. They are taxed on foreign income or gains only to the extent that such amounts are remitted to the UK. Although many will invest via structures, such as feeder funds or companies/trusts, the various rules which tax the individual on the profits of these structures make the analysis relevant to them as well. The AHC proposals present three particular issues for RBUs: whether (a) investing in an AHC is a remittance if foreign income or gains are used to invest in the AHC, and (b) income or gains derived from an investment in an AHC is UK or foreign source income or gains, and (c) whether an interest in an AHC is a UK situs asset for IHT purposes.

From the point of view of fund investors other than individuals who are involved with the fund (and even then only if they can invest directly into the AHC) it is impossible to address these issues fully without first considering the position of an investment into a fund partnership. In broad terms, an investment into a UK partnership will be a remittance, whereas an investment through a genuine, widely-held non-UK partnership should not give rise to a remittance even if the partnership invests in the UK. We are concerned that a fund manager who looks to RBUs as a source of investment would not use a UK AHC. As things stand, such a manager would not use a UK fund partnership. If he cannot use a UK fund partnership, he is most unlikely to use a UK AHC

for two reasons. Firstly, he is likely to want to co-locate as many functions as possible and having a fund and an AHC in different jurisdictions is the antithesis of this. Secondly, if a non-UK partnership only invests in a UK AHC, this puts pressure on the remittance analysis.

We are very conscious of the scope of this consultation, but it seems to us that if the investor-level issues are not addressed, managers who look to RBUs as sources of finance will not use UK AHCs. From the direct experience of our members, we are aware of funds which have decided on their jurisdiction as a result of looking to RBUs for finance. In one case a fund was being set up in the UK and was moved to Luxembourg at the last minute to accommodate a RBU making a significant investment. Private banks will ask whether particular funds are suitable for RBUs when reviewing investments they can offer to clients and will tend not to include funds which are unsuitable for RBUs in their portfolio of options.

A significant number of fund managers are RBUs themselves. They may be able to avoid the partnership-level concern by investing in the AHC directly, but without more that investment would be a remittance. Ideally a UK AHC would not force managers to invest in a way that is different from ordinary investors.

Income or gains derived from a UK AHC will be UK income and gains taxable on an arising rather than remittance basis.

A Luxembourg AHC would not present either of these difficulties. An investment into a Luxembourg fund partnership and through it into a Luxembourg AHC would not be a remittance, even if the AHC invested in the UK. Income and gains derived from a Luxembourg AHC would be foreign income and gains.

The IHT position needs to be mentioned. Generally, the location of the partnership interest will be relevant, which is normally where the business is carried on. Irrespective of whether the partnership is a UK partnership, there is a risk that this might be in the UK if the AHC and all the management is in the UK. There should therefore be a provision which treats such partnership interests as excluded property for IHT purposes – a bit like the exemptions which already exist for AUTs and OEICs. This is relevant to all non-UK domiciled investors, whether or not they are UK resident.

To compete effectively with a Luxembourg AHC on this point, the legislation should make it clear that (a) a direct investment into a UK AHC is not a remittance, nor is anything subsequently done by the AHC, (b) income and gains derived from a UK AHC (regardless of where it invests) are foreign income and gains, and (c) an interest in a UK AHC (whether held directly or though a partnership) is not a UK situs asset for IHT purposes. Even this is not a complete answer. Making this provision would allow fund manager RBUs to invest directly in the AHC. This is not possible for “ordinary” investors, as they will need to invest through a fund partnership vehicle with all the commercial provisions that would be expected there. To address their concerns, it will need to be made clear that an investment into a UK fund partnership which meets the GDO requirement is also not a remittance, nor is anything which the fund partnership subsequently does, and that such a partnership is not a UK situs asset for IHT purposes..

Distributable reserves

Further thought is required to ensure the distributable reserves position of the AHC can be managed to repatriate funds. One scenario where there may be a concern is where one portfolio company has been impaired in the accounts and there is then a realisation of another portfolio

company at a gain as the impairment will reduce what is treated as realised earnings (and distributable) in relation to the realised portfolio investment. To a large degree this may be managed by reductions of capital to create realised earnings or a share buy-back out of capital. It is not impossible to imagine scenarios where company law traps funds inside a company, although they should be extremely remote.

If this is thought to be a concern, one solution would be to "turn off" the ordinary UK company law maintenance of capital rules and allow an AHC to make distributions to its shareholders in all circumstances as long as it is solvent afterwards or to allow an AHC to be financed by a debt instrument returns on which would be treated like a return on an excluded indexed security. The former would be preferable as a complex debt instrument raises obvious difficulties.

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

As set out above, we consider that a complex 'tracing' mechanism by which income and gains are attributed to investors would create a barrier to entry into the AHC regime, would be uncompetitive from an international perspective, and as such is undesirable.

Investors may have interests in a mix of shares, preference shares and loan stock, depending on the objectives of the particular AHC in question. In a funds context it is unlikely that any investor would hold these instruments directly; the instruments would be held by the fund (or by a nominee on behalf of the fund) and effective ownership of the instruments would be determined from time to time by the operation of the fund's constitutional documents, such as a limited partnership agreement.

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

As set out above, we consider that modification to the effect of S.383 ITTOIA 2005 is key to delivering a workable AHC regime that the funds industry adopts in practice.

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

We have explained above that we think this risk is very low. It does not justify making the AHC regime complex to operate.

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

We consider that the AHC will need to accommodate such an outcome if the AHC is to be competitive with Luxembourg for certain credit strategies. If it is Government's wish to be competitive in this regard then the AHC must deliver both tax neutrality in respect of the underlying profit in the AHC's hands, and a capital return to investors.

The capital return to investors could be achieved via a debt instrument or via a share buy-back, with the modifications to the distribution provisions outlined above.

Tax neutrality could be achieved either via a tax deduction being available for the onward payment to the AHC investors, or via the receipt into the AHC being exempt. In the former case, provision would need to be made to ensure that the timing of the deduction matches the timing of the income in the AHC; in order to provide certainty on this point, tax provision would be far preferable to relying on the accounting treatment to 'match', given the need for certainty to secure take up of the AHC regime.

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

For private equity funds we think that it will be important to allow group relief surrenders from AHCs into the UK portfolio companies owned by the fund. This is because the typical investment structure for private equity funds will involve a single master holding company and then a chain of 3 or 4 100% owned (ignoring possible management shareholders and co-investors) holding companies. The chain of holding companies is to facilitate shareholder and third party borrowing to fund the relevant portfolio company investment. The number of intermediate holding companies is determined principally by finance providers' requirements for security and structural subordination reasons rather than for tax. The bottom holding company in the chain will be the purchaser of the portfolio company.

For the AHC regime to be attractive for private equity funds, it will be important that:

(a) each holding company in the portfolio company ownership chain can qualify as an AHC; and
(b) interest deductions on the third party and shareholder debt can be group relieved into the portfolio company group.

If this were not permitted, then the companies borrowing funds could not be AHCs and this would remove many of the advantages of using a UK AHC structure to acquire UK portfolio companies.

We appreciate that the rules surrounding group relief might have to be considered carefully in the context of the preferred tax basis that will be available to AHCs (most obviously, so that there is no possibility of the same financing cost being effectively deducted more than once), but think that this could, for instance, be dealt with by simply applying the standard UK corporate group relief limitation rules to the AHCs.

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

We do not think that any corporate restriction rules should apply to the profits of AHCs themselves but appreciate that some of the intragroup transfer rules in TCGA 1992 might have to be looked at if they could result in transfers from non-AHCs to AHCs to simply avail of the AHC CGT exemption, if that is how the AHC rules operated. We think that it would be important, however, for other rules, such as the CGT reorganisation rules, to operate through AHCs to avoid tax charges that would not have arisen if the reorganisation had been undertaken to group companies which were not AHCs.

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

We think that it would be important to allow companies that meet the eligibility criteria (and, maybe, have met them since their establishment) when the rules are introduced to be able to elect to become AHCs without any adverse tax consequences (so no tax charge for the company or investors on such companies joining the regime).

We think that any concerns around abuse and avoidance should be dealt with through the robust eligibility requirements discussed earlier in the consultation document and that there should not be any requirement for specific anti abuse/avoidance provisions.

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

A company which leaves the AHC regime (by choosing to leave, being sold or otherwise failing to meet the criteria to be an AHC) should make a deemed disposal and reacquisition of its assets at market value. Any profits up to that point would benefit from the AHC regime and future profits would not. There is no need to impose any tax at investor level. UK resident taxable investors will be taxed in due course when they sell their interests in or receive returns from the AHC and other investors should not suffer a tax charge because the company has left the AHC regime.

We would be strongly against any provision that might result in a tax charge for fund investors before they realised any value from the fund and that was not aligned with them receiving returns from the fund. This alignment of receipts and tax for investors is critical to the way in which private funds operate and their investors' expectations. Any suggestion that fund investors might be treated as realising taxable profits would significantly undermine the likelihood that a UK AHC regime was widely adopted.

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

Again, we think that this concern, if it is considered to be a significant concern, would need very careful thought. The simpler and clearer the criteria for entering the AHC regime, the less likely this is to be a real concern.

It would undermine the AHC regime if funds and their investors thought that unexpected tax liabilities might arise because it was claimed, following the winding up of an AHC and return of whatever assets were distributed on the winding up to the fund's investors, that the company was not, in fact, an AHC.

This issue arises because fund structures generally look to return realised sums to their investors as soon as possible after the fund vehicle (generally a limited partnership) receives them and it would then be problematic to seek to recover distributed amounts from investors.

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So, if the government considered that some protections were required in this regard, it would be important that the circumstances in which a potential post-winding up tax charge could arise were very clearly specified and were very much the exception rather than the rule. It might also be helpful to have a clearance process in place that allowed funds to get confirmation from HMRC before winding up an AHC that there would be no attempt to claw back tax in the future.

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

As set out above, joining and leaving the regime should be as straightforward as possible and should not result in any adverse tax consequences for the AHC or investors (and, in particular, any mismatch between tax and receipts).

Insofar as dividends and gains are concerned, there is, in our view, no obvious need for a new accounting period to begin when a company enters or exits the regime.

We recognise, however, that where the regime effectively allows the AHC to be taxed on a margin basis in respect of financing arrangements through the AHC (which we strongly encourage and may necessitate changes to the application of the loan relationship rules, including hybrids) it would probably be sensible to have a mechanism which delineated between periods within and without the regime and the beginning of a new accounting period for tax purposes may be the simplest way to do that.

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

This will depend in large part on how prescriptive the eligibility conditions are – see answers to Qu. 1 – 14 above. If the conditions are broad and straightforward, the circumstances where an AHC ceases to qualify temporarily should be few and far between, or even non-existent.

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

As set out elsewhere in our responses, the key to the success of any AHC regime will be simplicity and certainty. Any aspects of the UK tax regime which continue to apply to AHCs and therefore create uncertainty, compliance cost or the risk of additional tax leakage in the UK will be unattractive:

- CFC rules: absent a specific exemption for AHCs, most AHCs will need to run a CFC analysis in respect of their portfolio companies. While, in most cases, we would not expect any CFC attributions to arise, it is an additional compliance burden in the context of a regime which is designed to facilitate investment in the UK (in which case there is no CFC risk) or outside the UK (with minimal tax leakage in the UK on returns from that investment). The application of the CFC rules in that context is counter-intuitive (and counter-productive) and could be cleared with a specific exemption in Part 9A TIOPA.

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- CIR / Fair Value Movements on Loans and Derivatives: again, these rules create compliance cost and the risk (particularly in the context of financing arrangements through AHCs and funds with a significant debt or credit focus) of more than just a marginal tax cost on returns through the UK and any amendments to or disapplication of these provisions insofar as they relate to AHCs should be considered seriously so that AHCs predominantly benefit from a margin-based form of taxation.

- As a UK company there will be stamp duty on transfers of shares in UK AHCs, which there would not be in the case of non-UK holding companies. It is entirely possible that a fund and other investors in a UK AHC may prefer to sell their shares in the AHC, particularly if one investor wanted to dispose of its investment. To avoid the risk of stamp duty discouraging the use of UK AHCs, transfers of shares in UK AHCs should be free of UK stamp duty and SDRT.

- Unexpected Forex issues, eg on contracts for staggered investments. A UK AHC investing around Europe or more widely will be more exposed than many non-UK AHCs to forex risk given that sterling is the currency of the UK only.

- The fair value rules under CIR can cause significant distortions in particular, although we recognise that elections can be made under section 456 TIOPA to counteract some of the effects of that.

- Exemption for Dividends and Distributions: the conditions for exemption under Part 9A CTA 2009 are different for companies that are small and companies that are not small. The second category is much more wide-ranging.

  We recommend, therefore, that:

  - 931S be amended to include AHCs in the list of entities that are not to be regarded as small; and

  - an additional exempt class be considered in respect of distributions to AHCs (to simplify the analysis and create certainty).

In relation to the tax treatment of investors, see answers to questions 25 – 31 above.

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

See suggestions above.

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

The most common example in our industry is Luxembourg – a summary of which is included in our answers to questions 25 – 31 above. Other examples include Ireland and to a lesser extent (and depending on where the relevant fund is investing) offshore jurisdictions, such as the Channel Islands.

What they all largely share, however, is a regime which either through specific exemptions or, more commonly, through:

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- exemptions which are available to corporates generally in those jurisdictions; and

- CT regimes which contain less prescriptive BEPS (and avoidance) measures,

allows returns to repatriated to investors with no or only marginal tax leakage.

Q47: Please highlight any inherent features of the proposed regime that you consider protect it against abuse and set out what additional anti-avoidance rules you consider might be desirable.

We consider that a well-defined, targeted set of eligibility criteria enabling a company to enter the regime should be the mechanism through which most protection from abuse of the AHC regime should be achieved. Indeed we think that it is important to the successful operation and take up of the regime not to incorporate additional anti-avoidance provisions into the regime itself since this risks deterring funds from using AHCs. There are tried, tested and well used structures (e.g. in Luxembourg) that are not subject to additional anti-avoidance rules and we expect that most funds will not wish to use AHCs where there is, even incrementally more, anti-avoidance risk than other alternative holding company regimes available to them.

Our view is that it is key to ensure that the regime is only available to those for which the regime has been designed, such that the use of AHCs does not become more widely or inappropriately used. Once a company has determined that it falls within the regime, it is then key that the regime applies without the uncertainty of further anti-avoidance rules applying (beyond those rules that are already incorporated within UK legislation e.g. the GAAR,).

Q48: What information, either listed in paragraph 4.156 or otherwise, do you think HMRC should collect to maintain the AHC regime as low risk and provide a high-level understanding of how it is used?

Q49: Do you have suggestions for an XBRL taxonomy for these items? What are your views on whether tagging would be a convenient and reliable method to ensure that information is provided?

The regime should not confer significant additional reporting requirements on AHCs as compared to ordinary holding companies outside the regime. We suggest that a short annual confirmation could be included in the tax return of an AHC to demonstrate to HMRC that the company has considered as part of the self-assessment regime that the criteria to be an AHC continue to be met. This could include the explicit confirmation on each of the criteria and include details of the asset manager.

It is not clear why a number of the points set out in 4.156 would be needed in order for HMRC to ensure compliance with the regime or enable the identification of abuse. As we have set out already, we consider that complex tracking of underlying returns to determine repatriation mechanisms to investors would be a significant barrier to entry and would be likely to limit take up of the regime and perhaps some of the points listed at 4.156 are aimed at gathering information on how such a tracking mechanism has been operated in practice.

We note that a number of the details set out at 4.156 will already be included in the statutory accounts of a company (e.g. paid up share capital, debt issued, value of the portfolio) and so if these details are required, we do not see much additional value in having to also include these details in the tax return itself. As the accounts of a company are submitted to HMRC in iXBRL

format already, we would anticipate that any necessary tagging could be undertaken as part of the tagging of those accounts.