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Section 14 and Schedule 2: qualifying asset holding companies

On 11 March 2020, HM Treasury launched a stage 1 consultation on the tax treatment of asset holding companies in alternative fund structures as what it said was an "opening step" in a planned review of the UK funds regime.[1] Just over two years later, on 1 April 2022, such asset holding companies were able to benefit from this new regime.[2] The speed at which the government moved from exploration of the issues to design and then delivery (in the form of Schedule 2 to the Finance Act 2022 (FA 2022)) of this new regime demonstrates its commitment to supporting the UK's sizeable asset management sector.

This new regime is focused on one particular aspect of the funds sector: the use by funds of single purpose companies to hold specific investments. Those investments could be shares, debt, land or infrastructure, depending on the fund's investment strategy. Returns from those investments are ultimately passed on to the fund's investors. For the fund, a key objective is trying to ensure its investors are in no worse position, in tax terms, as a result of the use of such "asset holding" companies (AHCs) than if they had invested directly in the underlying assets.[3]

The new regime is, in broad terms, intended to ensure that this key objective can be achieved by funds that chose to set up an AHC in the UK. Responses to the March 2020 consultation led to the government deciding that the best way to make the types of "targeted tax changes that could help to make the UK a more competitive location for AHCs" was to introduce a new "appropriately targeted, proportionate and internationally competitive tax regime for AHCs".[4] The aim of that regime, according to the government, is to ensure that an AHC only pays UK tax of an amount that is commensurate with its (limited) role within a fund (that is, simply

[1] HM Treasury, *Tax treatment of asset holding companies in alternative fund structures: consultation* (10 March 2020), *https://www.gov.uk/government/consultations/tax-treatment-of-asset-holding-companies-in-alternative-fund-structures* [Accessed 19 September 2022], para.1.6.

[2] Finance Act 2022 Sch.2 para.14(3): What is even more notable is the very short window officials had to work on draft legislation. An initial draft (of part, not all, of the regime) was released on Legislation Day (L-day) in July 2021. By the time the Finance (No.2) Bill was ordered to be printed on 2 November 2021, that initial draft had been revised, in places completely rewritten and updated—more than tripling in length (from 11 pages to 36)—and only one amendment was made during its parliamentary process.

[3] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response and second stage consultation* (15 December 2020), *https://www.gov.uk/government/consultations/taxation-of-asset-holding-companies-in-alternative-fund-structures-second-stage-consultation* [Accessed 19 September 2022], para.2.37.

[4] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response and second stage consultation* (15 December 2020), Executive Summary and paras 1.2, 2.36–2.37, 4.2–4.5 and 4.51–4.52.

facilitating the flow of income and capital between investors and investment assets).[5] That way, the key objective should be met (as UK tax leakage in the fund structure—the UK tax wedge referenced by the consultation—should be minimal).

The government's initial thinking on the design of the new regime is detailed in Chapter 4 of the second stage consultation on AHCs published in December 2020. Chapter 3 of the July 2021 summary of responses to that consultation evidences how that thinking evolved over the consultation process[6]: it is an interesting read and illuminates some of the policy trade-offs that had to be made (and for those who may have to apply these rules in practice, together with the extensive HMRC guidance set out in HMRC's *Investment Funds Manual*,[7] provides very useful context to the rules). What is clear from these Chapters is the attempt to balance Exchequer risk by providing for "robust eligibility criteria"[8] with the need for the regime to be sufficiently straightforward (and easy to access) so that the UK is seen as a viable alternative to existing (and popular!) AHC jurisdictions (for example, Luxembourg). After all, if there were too many hoops, who would want to jump through them given the other very familiar options remaining available?

This note cannot deal in detail with all the provisions in Schedule 2 FA 2022 and so what follows is a summary of the main elements of the new regime.

Schedule 2 Finance Act 2022: overview

Schedule 2 FA 2022 is introduced by section 14 FA 2022. It is divided into 12 separate Parts, each dealing with a particular aspect of the new regime, starting with eligibility (in Part 1), followed by joining and leaving the regime (in Parts 2 and 3) and with Parts 4 to 11 containing the adaptation of existing UK tax rules (corporation tax, income tax, stamp duty and stamp duty reserve tax and the remittance basis[9]) to try to ensure effective tax neutrality for an AHC that meets the eligibility criteria (a QAHC—standing for "qualifying asset holding company"[10]). Part 12 is mainly (but not exclusively) about definitions.

As you read through the different Parts of Schedule 2 FA 2022, there are, in some places, strong echoes of other UK regimes, both in legislation and approach. For example, the provisions dealing with becoming a QAHC (in Parts 2 and 4) appear to borrow from the real estate investment trust (REIT) rules (including the concept of ring fencing particular activities for tax purposes

[5] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response and second stage consultation* (15 December 2020), Executive Summary and paras 1.2, 2.36–2.37, 4.2–4.5 and 4.51–4.52.

[6] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response and second stage consultation* (15 December 2020); and HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response to second stage consultation* (20 July 2021), both at *https://www.gov.uk/government/consultations/taxation-of-asset-holding-companies-in-alternative-fund-structures-second-stage-consultation* [Accessed 20 September 2022].

[7] HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM40000, "Qualifying Asset Holding Companies".

[8] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response to second stage consultation* (20 July 2021), para.2.2.

[9] The main tax "missing" from the new regime is VAT. In March 2020, the government announced a review of how VAT applied to fund management fees—but as yet there has been no public consultation on VAT as it applies to funds (despite statements at various times suggesting publication would be "soon" (including at Spring Statement 2022).

[10] Finance Act 2022 (FA 2022) Sch.2 para.1(1).

and an entry charge[11]); the modifications to the genuine diversity of ownership (GDO) test in Part 1 seem to be mainly "cut and paste" from Schedule 5AAA to the Taxation of Chargeable Gains Act 1992 (the influence of which can also be seen in the provisions that allow for cure periods where there is a breach of certain eligibility criteria) and the dis-application of distribution treatment in section 1015 of the Corporation Tax Act 2010 (CTA 2010)[12] is very much out of the securitisation company regime playbook. That being said, Schedule 2 FA 2022 still provides plenty of new drafting (and indeed new approaches to familiar issues) to get to grips with—particularly given the number of existing tax provisions that are amended by it to ensure that the regime achieves its objective.

The reason why so many existing tax provisions need to be amended by Schedule 2 FA 2022 is that, notwithstanding the tax benefit conferred by Schedule 2 FA 2022, a QAHC remains a normal corporation tax paying company (and so pays the applicable rate of corporation tax on its profits and gains)[13]—important in terms of potential eligibility for treaty benefits. Part of what Schedule 2 does, therefore, is to determine what amounts should and should not be taken into account when computing an AHC's profits and gains for corporation tax purposes (whether an item of income or an expense—with the latter, for these purposes, basically meaning financing costs[14]).

To complicate matters (slightly), how that determination of profits is carried out will depend on the nature of the assets owned by the AHC. For some types of asset, Schedule 2 FA 2022 leads to an exemption from corporation tax; for others, the objective is to reduce the amount of the "tax wedge" between direct and indirect investment that would otherwise be created by UK tax rules[15]—but if the asset held by the AHC is UK real estate (or shares in a UK property-rich company), Schedule 2 FA 2022 has limited effect (and the government was clear throughout the consultation process that normal corporation tax rules would apply to UK property without any modification[16]).

Finally, the regime lacks any general anti-avoidance provision—quite rare in modern legislation. Although Schedule 2 FA 2022 includes a couple of specific (and so narrowly drafted) anti-avoidance rules,[17] the government is basically relying on the eligibility criteria to ensure that the regime cannot be taken advantage of by those not intended to be within scope.

[11] The REIT entry charge was of course abolished in Finance Act 2012 Sch.4 para.33.
[12] FA 2022 Sch.2 para.44.
[13] In this way, the QAHC regime differs from the rules that apply to securitisation companies (under which the amount of taxable profit to be brought into account is specified in regulations rather than determined using corporation tax principles).
[14] And hence the need to amend certain rules relating to loan relationships, hybrid mismatches, the corporate interest restriction and transfer pricing.
[15] HM Treasury, *Tax treatment of asset holding companies in alternative fund structures: consultation* (10 March 2020), paras 2.12 and 4.6.
[16] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response to second stage consultation* (20 July 2021), para.3.36. At an earlier stage in the consultation the government mooted the possibility of preventing a QAHC from carrying on a UK property business.
[17] See for example FA 2022 Sch.2 paras 36, 37 and 48.

"Qualifying activities" of a QAHC

The eligibility criteria for a QAHC includes a requirement that the QAHC's main activity is carrying on an investment business,[18] but the tax benefits that the regime confers are limited to specific types of investment business only. As referenced above, Schedule 2 FA 2022 borrows from the approach taken in the REIT regime by placing a ring fence around the specific activities of the QAHC that are favoured by the regime.[19] These activities are, in broad terms, linked to particular types of fund investment strategy—private equity, credit and real estate. Hence, the definition of "QAHC ring fence business" in paragraph 20(1) of Schedule 2 FA 2022 which lists activity in relation to ownership of qualifying shares,[20] debt (where the QAHC is a creditor only) and overseas real estate (but only where the income from it is exempted under the rules).

Although non-QAHC business is not specifically defined, it would include (direct or indirect) ownership of UK land, receipt of a property income distribution (a PID) from a REIT and any trading activity.[21]

If a QAHC carries on QAHC ring fence business and non-QAHC business, it is treated as two companies (not one), which may mean that income, expenses and assets need to be apportioned between the QAHC and non-QAHC deemed companies (and as is the case for REITs, there is no ability for QAHC activities to access tax attributes of the non-QAHC activities, or vice versa).[22] In many cases, however, the QAHC will be a single purpose company, with all its activities within the QAHC ring fence, simplifying compliance.

A further consequence of the QAHC ring fence is the need to provide for what happens if certain assets held for the purposes of the QAHC ring fence business becomes used in the non-QAHC business (or vice versa). Again, the influence of the REIT rules can be seen: moving in and out of the ring fence results in a deemed market value disposal—where the move is *in* to the ring fence, a tax charge could result (but if qualifying shares or overseas land move *out* of the ring fence, the QAHC tax exemptions should apply).[23] Moves between QAHC and non-QAHC activities should generally be intentional (and so can be managed), but where a QAHC invests (indirectly) in both UK and overseas land through a common holding company, shares in that holding company could switch between non-UK property richness to UK property richness (and so in and out of the ring fence) simply as a result of the sale of a property (or even a change in relative values).[24]

Tax benefits of QAHC status: determining its taxable profits and gains

The qualifying activities of a QAHC influence its tax status in relation to particular income and gains. As referenced above, the overall aim of the regime is that the amount of tax a QAHC pays

[18] FA 2022 Sch.2 paras 2(1)(c) and 13(1).
[19] FA 2022 Sch.2 para.20.
[20] Shares other than shares in a UK property-rich company: FA 2022 Sch.2 para.53.
[21] HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM40350, "Becoming a QAHC: ring fence business".
[22] FA 2022 Sch.2 paras 20(2)-(9) and 33–35: the separation of the QAHC and non-QAHC activities applies within the QAHC and across the group of which the QAHC is part.
[23] FA 2022 Sch.2 paras 22 and 53: note also para.23 to deal with double counting.
[24] See examples in HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM40375, "Becoming a QAHC: moving assets out of the ring fence" and IFM40380, "Becoming a QAHC: crossing the ring fence".

on its profits is commensurate with its activities. For some of its qualifying activities (ownership of qualifying shares and overseas property business), this basically means no tax. For credit funds (where an AHC either advances or acquires loans to other companies) a different approach is taken—as income profits remain taxable under the loan relationship rules, Schedule 2 FA 2022 focuses on the relief available to a QAHC for its own financing costs to offset against those profits.

QAHC corporation tax exemptions

Where a QAHC invests in qualifying shares or an overseas property business, exemption is achieved through a combination of existing corporation tax rules and specific exemptions within Schedule 2 FA 2022.

For a QAHC that invests in shares, as dividends should be exempt from corporation tax under Part 9A of the Corporation Tax Act 2009 in any event, nothing further was needed. For gains on disposals of shares, although the UK rules provide for a substantial shareholding exemption (SSE), the conditions attached to SSE meant that it could not be assumed to be available in all cases. As a result, Schedule 2 FA 2022 includes a specific exemption for gains arising on a disposal of qualifying shares.[25] Unlike SSE, the QAHC gains exemption is absolute—in particular, there is no minimum holding requirement and it is irrelevant whether the company being sold is a trading or an investment company.[26]

An absolute gains exemption also applies on a disposal of overseas land.[27]

The final exemption from corporation tax is for profits of an overseas property businesses.[28] This exemption is, however, conditional (not absolute)—though in most cases the pre-condition should be met. This is because the pre-condition is that the overseas property business profits are taxable overseas (which should generally be the case as most, if not all, jurisdictions preserve the right to tax income from immovable property).[29] Although a UK company carrying on an overseas property business would be able to access double taxation relief (which, in some cases, would have resulted in de facto UK exemption in any event), the government accepted the need for an actual exemption if funds were to be willing to use UK companies to hold overseas property.[30]

[25] FA 2022 Sch.2 para.53: note that the meaning of "shares" is extended to include interests in certain types of collective investment vehicle, including some unit trust schemes.

[26] The government preference was for a specific CGT exemption for QAHC rather than broadening the scope of SSE (and thankfully decided against a more complex approach based on roll-over relief): see HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response and second stage consultation* (15 December 2020), paras 3.11–3.13 and 4.76–4.88.

[27] FA 2022 Sch.2 para.53(1); and see HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM40920, "Gains exemption: overseas land".

[28] FA 2022 Sch.2 para.52. HMRC's guidance provides examples as to how the exemption works at HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM40815, "Overseas property business: overseas property income: examples".

[29] HMRC, Internal Manual, *Investment Funds Manual* (2022), IFM40815, "Overseas property business" illustrates the application of the exemption.

[30] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response and second stage consultation* (15 December 2020), paras 2.70–2.72 and 3.37.

(It is worth noting that the combination of these two exemptions places a QAHC at an advantage over a REIT on investment in overseas property. This is because, although a REIT may have similar exemptions, any distribution of (exempt) overseas property business profits is as a PID (taxable as property income of the investor), whilst a QAHC can pay a normal dividend. This could explain the reference to "discussions on the interaction of REITs with the new QAHC regime" in the summary of responses to the *Review of the UK funds regime: call for input*.[31])

For all other categories of income and gains, normal corporation tax rules apply. This includes (as referenced above) income and gains from UK real estate (including PIDs), gains on a disposal of shares in a UK property-rich company and trading income (although given the activity condition,[32] a QAHC would be unlikely to be trading).

Further, of more significance (and as referenced above), there is no exemption for finance income of a QAHC—so, for a QAHC in receipt of material amounts of interest income, the availability of relief for its own financing costs is critical to its ability to meet that key objective (that is, ensuring its investors are in no worse position that if they had invested directly).

Increased relief for financing costs

Common to fund structures is the use of profit-participating loans (PPLs) as a means of funding AHCs, given the flexibility they provide in terms of passing on investment returns to investors. The return on a PPL is results-dependent by definition and so the UK distribution rules would mean interest could not be deducted for tax purposes. During the consultation process, stakeholders emphasised the importance of the new regime allowing interest on PPLs to be deductible.[33] The government listened, and as result the first draft of the QAHC provisions dis-applied distribution treatment for results-dependent interest.[34] By the time the Finance Bill had first been ordered to be printed a few months later, other possible categories of distribution that could be relevant to how an AHC could be funded had also been dis-applied—including (importantly) securities where interest may be in excess of a reasonable commercial rate of return (avoiding the need to prove that a very high rate of return on a PPL is "commercial" factually).[35]

There are a number of other provisions in Schedule 2 FA 2022 also aimed at ensuring a QAHC is able to fully relieve its interest expense. The loan relationship late paid interest rules are disapplied and the hybrid mismatch rules tweaked (again to accommodate PPLs).[36] There is one important limit to note in relation to these provisions though—they only apply where the relevant financing costs relate to the QAHC's qualifying activities (that is, the QAHC ring fence business).[37]

[31] HM Treasury, *Review of the UK funds regime: a call for input—Summary of responses* (10 February 2022), *https://www.gov.uk/government/publications/review-of-the-uk-funds-regime-a-call-for-input* [Accessed 23 September 2022], paras 2.50 and 2.56.
[32] FA 2022 Sch.2 para.13(1).
[33] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response and second stage consultation* (15 December 2020), paras 2.43–2.48.
[34] HMRC, *Taxation of asset holding companies in alternative fund structures, Finance Bill 2021-22 draft clauses*, Issue date of consultation 20 July 2021, *https://www.gov.uk/government/publications/taxation-of-asset-holding-companies-in-alternative-fund-structures* [Accessed 23 September 2022].
[35] FA 2022 Sch.2 para.44.
[36] FA 2022 Sch.2 paras 45, 50 and 51.
[37] FA 2022 Sch.2 para.20.

This ensures, for example, that a QAHC that carries on a UK property business cannot get the benefit of this special treatment.[38]

There are also amendments to the corporate interest restriction so that, within a fund, it applies to defined AHC sub-groups (or stacks) rather than to a single worldwide group of which all AHCs owned by a fund are seen as members.[39]

But there is one set of provisions—transfer pricing[40]—where the application of existing rules has been extended, rather than curtailed. The government was clear that

> "[a]n AHC should not be able to obtain relief for any payments to investors that would reduce its profit below an amount commensurate with its role".[41]

The role of transfer pricing is to determine the appropriate (arm's length) profit to be brought into account by a company—and so the government has structured the regime so that transfer pricing rules always apply to determine the (commensurate) taxable margin that a QAHC must earn from its activities. This has necessitated dis-applying the exemption available for small and medium sized enterprises[42] as well as deeming each fund investor to be connected with the QAHC for transfer pricing purposes (regardless of the size of their investment).[43]

Reliance on transfer pricing rules to determine a QAHC's taxable profit means account can be taken of all material factors, but does create a degree of uncertainty (as contrasted, for example, with the position under the Taxation of Securitisation Companies Regulations 2006[44]). HMRC have however published specific guidance on how to approach a QAHC transfer pricing analysis within their *Investment Funds Manual*, with the comment (intended to be reassuring it seems!) that, in many cases, the nature of the QAHC's activities means that it "will be expected to retain no more than a marginal return reflecting its limited functionality".[45]

Qualifying as a QAHC: the eligibility criteria

Seven conditions need to be met for an AHC to be eligible for the regime. Of these conditions, three are straightforward (UK residence, not a REIT and not listed), one is effectively a filing obligation (the need for an entry notification to have been made and still be in force) and the remaining three have varying degrees of complexity (in part because they are more closely

[38] FA 2022 Sch.2 paras 44(5), 50(3) and 51(3) and definition of "qualified distribution" in Sch.2 para.45.
[39] FA 2022 Sch.2 paras 50 and 51, 45, 42 and 43 respectively: the provisions relating to hybrids and the corporate interest restriction were not included in the July 2021 Finance (No.2) Bill draft clauses but the fact that such provisions were being considered was highlighted in the summary of response issued alongside.
[40] FA 2022 Sch.2 paras 40–41.
[41] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response and second stage consultation* (15 December 2020), para.4.69.
[42] FA 2022 Sch.2 para.41, disapplying Taxation (International and Other Provisions) Act 2010 s.166(1).
[43] FA 2022 Sch.2 para.40 under which the participation condition (which means transfer pricing applies) is deemed met as between the QAHC and any person with a "relevant interest" in that QAHC (broadly an equity-type interest). See HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM40650, "Other tax issues: transfer pricing: introduction and legislative changes".
[44] Taxation of Securitisation Companies Regulations 2006 (SI 2006/3296): under these regulations, the taxable profit of a securitisation company's profit is determined using a formula (and then substituted for the company's corporation tax total profits in computing its liability to tax).
[45] HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM40660, "Other tax issues: transfer pricing: accurate delineation" and IFM40670, "Other tax issues: transfer pricing: pricing".

connected with arrangements relating to the specific QAHC and so involve more than just "ticking the box").[46] These latter three are the activity condition, the investment strategy condition and (the most complex of the three) the ownership condition.

The activity condition in paragraph 13(1) of Schedule 2 FA 2022 is intended to ensure that the benefits of the regime are only available to investment companies. However, the condition accepts that a QAHC may need to carry on limited (trading) activities: provided they are ancillary to the main investment business, they will not prevent the condition being met.[47] Here, the guidance gives an example of intra-group management services.[48] If ancillary trading activities are carried on, any profits from them are taxable—but if the trading activities are not ancillary or (even if ancillary) carried on to a substantial extent, then the condition is breached and the QAHC may have to leave the regime (see below).

A question of fact, working out whether an activity is investment or trading should in many cases be straightforward but there are always grey areas—and the strategy of some funds, particularly those that invest in debt, can sometimes appear a very dark shade of grey. In the summary of responses to the second consultation, HMRC said they recognised the uncertainties here, and planned to consult with a "view to determining a test of investment activity which offers greater certainty than existing law".[49] This has not been achieved within the legislation—but HMRC have now published five relatively detailed examples of credit fund strategies that comment on how the badges of trade might be expected to apply.[50] HMRC's views are carefully hedged, but nevertheless the examples offer useful insight into HMRC's likely approach to questions that many an adviser has struggled with over recent years as they try to adapt 1950s "badges" to strategies employed by 21st century fund managers to maximise returns.

The investment management strategy condition supplements the activity condition by excluding investment activity deriving from a strategy of investing in listed securities, although here there is a carve-out directed at private equity "public to private" bid strategies. HMRC explain this condition, which was not included in the July 2021 draft clauses, as necessary to prevent use of the QAHC regime for converting (taxable) dividend income into capital returns.[51]

The more interesting eligibility condition (particularly in terms of legislative approach) is the ownership condition in paragraphs 3 to 11 of Schedule 2 FA 2022. The basic approach is straightforward—like REITs and the fund exemption election in Schedule 5AAA to the Taxation of Chargeable Gains Act 1992 (TCGA), the QAHC must be owned by a minimum level of "qualifying investors" (within the legislation "Category A investors"): although note the legislation is drafted as a negative condition (providing for a maximum (30 per cent) limit of non-Category

[46] FA 2022 Sch.2 paras 2, 3,13 and 14.

[47] This shows how government thinking evolved over the consultation: in the second AHC consultation, the government said it was "considering whether it would be appropriate to specify that an AHC should not trade", para.4.48.

[48] FA 2020 Sch.2 para.13 and HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM40255, "Eligibility criteria: activity condition".

[49] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response to second stage consultation* (20 July 2021), para.3.25.

[50] HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM40260, "Eligibility criteria: trade versus investment".

[51] FA 2022 Sch.2 para.13(2) and HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM40265, "Eligibility criteria: investment strategy condition".

A investors).[52] The list of Category A investors includes the usual institutional investor suspects (as per REITs and Schedule 5AAA TCGA) as well as other QAHCs (allowing for QAHC stacks, so that AHC subsidiaries of a QAHC parent should generally be able to meet this condition).[53]

For a fund to be a Category A investor, it must be widely held—this condition can be met by applying the classic non-close test (albeit tweaked in relation to the treatment of loan creditors), a modified non-close test (based on the REIT relaxation of the non-close condition where there are institutional investors) or a modified GDO test (borrowing the modifications from Schedule 5AAA TCGA) or (new to this regime) if it itself is at least 70 per cent owned by Category A investors.[54] Clearly the government is trying to be helpful by catering for as many different fund structures as possible, but all these options make for intricate drafting—and it could get more intricate given possible amendments by Finance Bill 2022–2023.[55] HMRC's guidance here is helpful—but the more complex the fund superstructure that sits above the AHC, the more challenging working out if the fund is a "qualifying fund" is going to be.

To work out whether the AHC has no more than 30 per cent of non-Category A investors, it is necessary to identify all "relevant interests" in the AHC.[56] "Relevant interests" are defined as equity interests (determined by applying group relief style tests concerning entitlement to profits on a distribution and assets on a winding up: another example of legislative borrowing[57]) and/or voting rights. Where an AHC has more than one class of interests, the ownership condition is worked out class by class (and if one class fails, the AHC as a whole fails).[58] When doing the maths here, it is possible for an AHC to have more than 100 per cent of relevant interests in it (like the group relief rules, the test takes account of the "greatest percentage" interest in each category)—but the legislation expressly tells you not to worry if the calculations result in what is after all a mathematical impossibility.[59]

A fund manager would be expected to be a non-Category A investor and so its carried interest could be a relevant interest in an AHC (although this will depend on how it is structured). As carried interest entitlement fluctuates over the life of a fund, it could potentially tip an AHC over the 30 per cent non-Category A limit in one or more periods. Showing HMRC's increasing understanding of how funds work (at a commercial level) and the need to accommodate that within the legislation, a smoothing mechanism has been introduced: under paragraph 5(5) of Schedule 2 FA 2022 the manager is treated as entitled to a constant amount each period (equal to its maximum proportional entitlement).

[52] FA 2022 Sch.2 para.3(1).
[53] FA 2022 Sch.2 paras 8, 9, 10 and 11: note 1) that the government has indicated that, even if sovereign immune investors lose their immunity, they are likely to remain Category A investors for QAHC purposes; and 2) where the Category A investor is a QAHC the anti-fragmentation rules discussed below.
[54] FA 2020 Sch.2 para.9.
[55] HMRC, *Taxation of asset holding companies in alternative fund structures, Finance Bill 2021-22 draft clauses, Issue date of consultation 20 July 2021*.
[56] FA 2022 Sch.2 paras 3 and 4.
[57] FA 2022 Sch.2 paras 3(2) and 5.
[58] FA 2022 Sch.2 para.3(1)(b).
[59] FA 2022 Sch.2 para.3(2)(3) and (5).

The general rule is that only direct interests in an AHC are taken into account when working out ownership of relevant interests and helpfully this extends to where the direct investor in the AHC is a (transparent) partnership that satisfies the definition of a qualifying fund.[60]

But fears of non-Category A investors finding novel ways to disguise majority ownership in an AHC to access the regime's generous tax benefits means that there is an exception to this general rule. Paragraph 4 of Schedule 2 FA 2022 includes anti-fragmentation rules. The drafting is tortuous. Their broad effect is to require tracing (to take account of indirect interests) in three situations, the easiest one of which to explain is where there is a QAHC stack[61] (for example, if each QAHC is owned 70/30 to "just" qualify, by the time you get two or three layers down the stack, the "true" percentage of Category A investors in the lowest QAHC would have been significantly diluted as a function of relatively simple mathematics). The other situation targeted by paragraph 4 of Schedule 2 FA 2022 is where a non-Category A investor invests directly and also indirectly (whether through a normal company or via a qualifying fund).[62] The complexities of these provisions cannot be underestimated—and just a few months after Royal Assent, HMRC are proposing an amendment intended to catch something that it seems they might have missed.[63]

To give credit to HMRC, the drafting of the ownership condition in FA 2022 is much improved as compared to the initial draft published in July 2021 (there was effectively a total rewrite over the summer to improve their sense) and the guidance does do a reasonable job of trying to explain how the anti-fragmentation provisions apply, with examples. But those examples, although helpful, are (understandably) simplistic: useful at illustrating principle, but perhaps not so useful at helping resolve real life fund situations.[64]

Again, reflecting the government's willingness to adapt the regime to reflect how funds work in practice, a new AHC can be eligible to be a QAHC even if it does not meet the ownership condition initially, provided it has a reasonable expectation of meeting it in its first two years (a ramp up period). Equally, when a fund is winding down, with investors leaving before the AHC is finally wound up, any resulting failure to meet the ownership condition may be able to be disregarded (so QAHC benefits remain for those final sales of assets) if certain conditions are met.[65]

The eligibility conditions all have to be met in each accounting period in which the AHC wants to be a QAHC. A breach of a condition means that the QAHC, no longer eligible, may have to exit the regime, but the influence of what has gone before (again, REITs and Schedule 5AAA TCGA) can be seen in paragraphs 27 and 29 of Schedule 2 FA 2022 which provides a QAHC with the opportunity to cure certain (non-deliberate) breaches of the ownership and activity conditions—if cured, the breach is deemed not to have occurred with QAHC status (and

[60] FA 2022 Sch.2 paras 6 and 9: note that within the legislation this applies to a qualifying fund that is tax transparent for gains and so is not restricted to partnerships.
[61] FA 2022 Sch.2 para.4(1)(c).
[62] FA 2022 Sch.2 paras 4(1)(b), (2) and (3) and 6(2).
[63] HMRC, *Taxation of asset holding companies in alternative fund structures, Finance Bill 2021-22 draft clauses, Issue date of consultation 20 July 2021*.
[64] HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM40220, "Eligibility criteria: ownership condition: FA22/SCH2/PARA4" and IFM40235, "Eligibility criteria: ownership condition: further examples".
[65] FA 2022 Sch.2 paras 14(2)(c) and (5) and 16 (ramp up) and para.28 (wind down).

benefits) generally uninterrupted (subject to one exception in paragraph 48 of Schedule 2 FA 2022).[66]

Entering the regime…

If the eligibility criteria are met (and so an entry notification has been filed), on the date specified in that entry notification the AHC will become a QAHC.[67] As is the position under the REIT regime, becoming a QAHC means a new accounting period then starts, and if the AHC already owns assets linked to what will be its QAHC ring fence (that is, qualifying) business, those assets benefit from rebasing as a result of a deemed market value disposal immediately before it becomes a QAHC—but here, unlike the current REIT rules, that deemed disposal could result in a tax charge (effectively an entry charge).[68]

For AHCs with an existing business, the entry charge is the quid pro quo for accessing QAHC benefits on future income and gains (it ensures that the QAHC exemptions only apply to profits and gains that arise whilst the AHC is a QAHC). Hence it does not apply to loan relationships held in their own right by a credit fund AHC.

Some readers will recall the REIT entry charge which applied from 2007 to 2012. The QAHC entry charge is very different. The REIT entry charge was a one-off charge, outside existing tax rules. For the QAHC entry charge, normal tax rules apply to work out the amount of tax due. This means that the AHC may be able to benefit from SSE on a deemed disposal of qualifying shares—particularly given the QAHC rules allow SSE to apply on entry where the shares have then been held for less than the minimum 12-month period (provided that the QAHC continues to hold them so that overall, taking account of ownership both before and after entry, the 12-month condition is met).[69]

The entry charge and related SSE adaptations were included in the July 2021 draft clauses. This suggested that, in practice, those AHCs that owned overseas land were the most likely to have to pay it. Given that land is normally taxed in the jurisdiction in which it is situate, investors will have often used local (or Luxembourg) AHCs. If the QAHC regime was intended to attract existing non-UK AHCs to the UK, a day one (and potentially material) tax charge would not appear to be the best marketing strategy.[70]

Another issue was where an investor had set up an AHC stack for a particular investment (an asset holding company and then a stack of intermediate holding companies between it and the fund): for stacks, there was the potential for multiple entry charges (at each level in the stack) all of which were based on the same underlying (property) gain with limited access to SSE on the deemed share disposals.[71]

[66] FA 2022 Sch.2 paras 27, 28 and 48: note that the QAHC has to notify HMRC when a condition is breached.
[67] FA 2022 Sch.2 paras 2(1)(g), 14(2)(b) and 15.
[68] FA 2022 Sch.2 para.17: the relevant assets are qualifying shares, overseas land and loan relationships/derivative contracts held for the purposes of a (to be exempt) overseas property business.
[69] FA 2022 Sch.2 para.17(4)(5).
[70] To benefit from the QAHC regime, the non-resident AHC would need to migrate its tax residence to the UK. Absent a rebasing on entry, the AHC could therefore face a material gain on entry into the regime—a gain referable to a period in which the AHC was outside the territorial scope of UK tax.
[71] Subject of course to qualifying institutional investor SSE where the applicable conditions are met.

This must have been recognised by the government as two further paragraphs were added to Schedule 2 FA 2022 by November 2021 relating to the entry charge. The first, paragraph 18 of Schedule 2 FA 2022, gives a company migrating to the UK a 30-day window in which to become a QAHC without having to pay the entry charge (if paragraph 18 applies, there is no deemed disposal on entry—this means the AHC retains its original base cost, but as long as it remains a QAHC, future gains are exempt anyway).

The second paragraph, paragraph 19 of Schedule 2 FA 2022, applies where an investor wants to elect an AHC stack into the regime. This paragraph provides a form of credit mechanism, intended to ensure that where the lowest AHC in a stack (AHC1) has entered the regime (and so is liable for the entry charge on, say, a disposal of overseas land), the entry charge payable by its parent (AHC2) on its deemed disposal of AHC1 shares is reduced by reference to the entry charge payable by AHC1 (and likewise if AHC2 is owned by a third AHC). Any reduction is on a "just and reasonable" basis, rather than by formula, but HMRC's guidance includes an example (helpfully). However, note that care is needed if relying on this paragraph—this is because, using the example above, AHC2's entry charge can only be reduced if it becomes a QAHC after AHC1.[72] If electing in to the regime is in the wrong order, no credit is available.

Once the QAHC is in the regime, ongoing compliance is basically normal corporation tax reporting with only limited QAHC-specific reporting requirements: this light touch approach was not originally expected (the consultation had suggested that QAHCs might have to separately track (and report) income and capital returns) and again shows the government's awareness of the need for the UK regime to be competitive.[73]

…and exiting the regime

The rules that apply on exit from the QAHC regime effectively mirror those that apply on entry: a notification is needed, a new accounting period starts and the assets that were held in the QAHC ring fence benefit from rebasing (and, as the deemed disposal takes place immediately before the company exits the regime, any gains should benefit from the QAHC exemptions)—again, very similar to the REIT rules.[74] But, unlike the REIT rules, the same rules apply when a QAHC chooses to leave the regime and where it exits because a condition has been breached (under the REIT rules, in some cases rebasing on exit can be dis-applied to prevent the risk of groups using REIT status to get a tax benefit from rebasing).[75] For QAHCs, only gains that accrue after exit will be taxable—and here the exit provisions also include their own SSE tweak: any deemed disposal of shares is ignored for SSE purposes so as not to affect continuity of ownership.[76]

[72] FA 2022 Sch.2 para.19(2)(b) and HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM40330, "Becoming a QAHC: entering with assets".
[73] FA 2022 Sch.2 para.24 and see HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response and second stage consultation* (15 December 2020), paras 4.101 et seq and para.4.156.
[74] FA 2022 Sch.2 paras 25, 29 and 31.
[75] See CTA 2010 ss.581 and 582.
[76] FA 2022 Sch.2 para.31(4). Also see FA 2022 Sch.2 para.34 for a further SSE tweak where qualifying shares are transferred between group members.

And finally, returning profits to investors…

Bearing in mind the aim of the regime is to remove any "tax wedge" between direct and indirect investment, the last piece of the QAHC jigsaw is what happens when the (mainly exempted) profits and gains of a QAHC are returned to investors.

As the UK does not impose withholding tax on dividends paid by a UK company, the regime's focus is on interest payments (including under a PPL) and repayment of share capital.

With PPLs respected as debt (given the dis-application of various distribution rules, as referenced above), part of the return received by investors would be interest for tax purposes (and could, given the links to profits, be of a material amount). The regime includes an absolute exemption from withholding tax on interest payable by a QAHC, relevant to PPLs but also to any third party debt. Further, this exemption has been extended to apply where, immediately following a sale of a QAHC to a non-Category A buyer (so QAHC status is lost), the buyer procures the repayment of existing debt to the buyer. This is a helpful add-on, allowing the market to continue to do as it has always done on corporate sales (and another example of the government showing its willingness to recognise what is commercial practice, albeit as a result of standard tax planning).

Where a QAHC repays share capital (at a premium), distribution treatment is generally switched off and so the repayment is within capital gains tax only (and so, for a non-UK investor, should be outside the scope of UK tax).[77] There are two exceptions to this: first, where the shares are employment related securities; and secondly, (some) repayments made whilst the QAHC is trying to cure a breach of the ownership condition—this exception represents one of the very few anti-avoidance provisions in Schedule 2 FA 2022.[78]

Plus, on a repayment of shares by a QAHC, no stamp duty or SDRT will apply (provided it is a genuine repayment and not an attempt to disguise a sale).[79]

There is one other provision of note in this context. A very targeted provision, it only applies to individuals who provide fund management services to the QAHC—and more particularly to fund managers who are non-UK domiciled and claiming the remittance basis. A UK QAHC is a UK situs asset, creating UK income and gains—even if its underlying investments are non-UK. Fund managers may be required to have an interest in the QAHC: not optimum for their management of their own liability under the remittance basis. So, amidst all the corporation tax rules in Schedule 2 FA 2022 is a provision that adapts the remittance basis for fund managers but only in a limited way (by providing that the source of returns from the QAHC for such fund managers is to be determined by reference to the situs of the underlying assets (and not the QAHC itself)), potentially bringing the mixed fund rules into play. Stakeholders had apparently asked for more[80] but perhaps it is understandable why only a limited change has been made given the politics attending this particular aspect of the UK tax system.

[77] FA 2022 Sch.2 para.47—unless of course the QAHC is UK property rich.

[78] FA 2022 Sch.2 paras 47(2) and 48: see HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM40740, "Treatment of certain payments: purchase of own shares".

[79] FA 2022 Sch.2 para.54: a similar exemption applies to loan capital.

[80] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response to second stage consultation* (20 July 2021), paras 2.116 and 3.68.

In summary…

Stepping back, the government has gone quite a long way to providing funds (and their investors) with a tax neutral corporate vehicle in the UK for holding their investments—with the length of Schedule 2 FA 2022 indicating the number of changes that had to be made to get there. The complexities of the regime mainly come from the eligibility criteria—or rather some of the eligibility criteria, particularly the ownership condition. In many cases though, testing compliance with that condition should be relatively straightforward; but in those cases where the fund superstructure is more complex, working out if an AHC is "in" or "out" of the regime could be challenging. It will therefore be interesting to see what take-up there is of this new regime—in particular, will all the hard work (by HM Treasury, HMRC and indeed stakeholder members of the QAHC working group) result in the "increased activity and jobs" that the government said that this new regime should lead to?

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