HM Treasury

The Tax Treatment of Asset Holding Companies in Alternative Fund Structures

Government response to second stage consultation

July 2021

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Executive summary

In December 2020, the government launched a second-stage consultation on potential reforms to the tax treatment of asset holding companies in alternative fund structures. This followed an initial consultation launched at Budget 2020 and is a key workstream of the government's wider review of the UK's funds regime, which is covering both tax and relevant areas of regulation.

This measure is seeking to build on the UK's existing strengths as an asset management hub. By making targeted tax changes to enhance the attractiveness of the UK as a location for asset holding companies, the government believes that the UK will attract increased activity and jobs as a result of the associated activity. Moreover, it is hoped that this will help to boost the UK's reputation as a funds domicile.

This exercise was supported by an extensive stakeholder engagement programme, including townhall and bilateral meetings across the full range of areas covered by the consultation, and a significant number of detailed and constructive responses were received. The government is grateful for the input of all who engaged with the consultation process.

Respondents to the second-stage consultation re-emphasised the extent of the opportunity and stressed the importance of effectively tailored yet proportionate design principles for a new regime. These include eligibility criteria, the extent and scope of any available exemptions, and other complementary reforms.

This publication summarises the responses received to the consultation. It also sets out the government's response to them. This incorporates the shape of the reforms that will be taken forward and next steps. There is, however, further work to be done ahead of any changes coming into force, and the government is keen to continue engaging with stakeholders.

Alongside this formal response, the government is publishing an initial set of draft clauses, covering key elements of the prospective asset holding companies regime. The government is currently intending to legislate for the regime in the next Finance Bill.

Chapter 1
Introduction

1.1 At Budget 2020, the government launched its first consultation on potential changes to the tax treatment of asset holding companies (AHCs) in alternative fund structures. This sought to understand whether there were targeted tax changes that could help to make the UK a more competitive location for AHCs.

1.2 The announcement of the AHCs workstream represented an initial step of the government's wider review of the UK funds regime. This overall exercise is looking at both tax and relevant areas of regulation, with a view to improving the UK's attractiveness for funds. A 'call for input' on the funds review closed in April 2021; the government is currently analysing the responses to this.

1.3 Following the first AHCs consultation, the government was satisfied that there was sufficient interest from stakeholders, including prospective users of any UK AHCs regime, to further progress work in this space. In particular:

- respondents suggested that the scale of the UK's asset management sector, its good infrastructure and skilled workforce would make the UK a competitive location for AHCs if barriers in the tax system could be addressed;
- respondents said that the establishment of AHCs in the UK could bring economic and fiscal benefits, primarily by bolstering the asset management sector and creating additional jobs in associated service sectors; and
- respondents set out areas where the UK tax rules currently create barriers to the establishment of AHCs, as well as proposing changes to the UK's existing Real Estate Investment Trust (REIT) regime.

1.4 With this in mind, the government launched a second-stage consultation on 15 December 2020. This focused on the detailed design features of a new elective regime for AHCs and closed on 23 February 2021. The consultation was supplemented by extensive stakeholder engagement, and 38 formal responses were received. The government is grateful for all of the input from stakeholders.

1.5 Having analysed the responses to the second-stage consultation, the government remains convinced of the case for implementing a new regime for AHCs. The intention is for legislation to implement an elective regime to be included in the next Finance Bill, and enacted in time to have effect from the beginning of the tax year 2022/23. The government will also be taking

forward reforms to the REITs regime; some of these will run to the same timetable as the AHCs legislation, whereas others will take longer.

1.6 This document summarises the responses received to the second-stage AHC consultation, across each of the areas it covered (Chapter 2). It provides detail on the government's decisions on how the future AHCs regime will operate, reflecting the representations made and necessary trade-offs (Chapter 3). And it sets out the next steps, including in relation to further stakeholder engagement (Chapter 4).

1.7 Alongside this summary of responses, the government is also publishing a set of draft clauses (covering certain core aspects of the future AHCs regime) for consideration. The government looks forward to discussing this draft legislation and specific design principles with stakeholders and proposes setting up a small but diverse working group for that purpose. Further details about joining the working group are set out in Chapter 4.

Chapter 2

Summary of Responses

2.1 The second-stage consultation asked 56 questions. These were split into two categories: those relating to the core design principles (and associated issues) of a new tax regime for AHCs and the case for reforms to the taxation of REITs, which could be taken forward to a similar timetable to complement the implementation of any AHCs regime. This chapter summaries the responses received to the questions in each category.

Section One: delivery of a new regime for AHCs

2.2 The government's objective is to deliver an effective, proportionate, and internationally competitive tax regime for AHCs that will remove barriers to the establishment of these companies in the UK. The new regime should include the following key features: robust eligibility criteria to limit access to the intended users; tax rules to ensure the AHC pays an amount of tax that is commensurate with its role; and rules for UK investors to ensure that they are taxed as if they had invested in underlying assets directly.

Eligibility

2.3 The consultation asked a series of questions related to eligibility, an area which is key to the successful operation of any AHCs regime and therefore of significant interest to stakeholders. The eligibility criteria of the regime will necessarily deal with a number of different issues. The key points made in responses are outlined below.

Criteria for investors

Question 1: Do you think an AHC regime should include arrangements where some or all investors invest directly at the level of the AHC, as discussed at paragraph 4.25? Can you provide evidence on how common these arrangements are?

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?

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?

2.4 Respondents indicated a number of situations where an entity or undertaking other than a fund may participate directly at the level of the AHC.

2.5 In relation to real estate, several respondents suggested that listed investment companies should be amongst eligible owners in order to use AHCs to hold multi-jurisdictional property portfolios. This would include investors such as UK REITs and their overseas equivalents, and other listed investment vehicles that would not necessarily meet the definition of a fund.

2.6 It was noted by some respondents that asset management executives may hold their interests at AHC level – either directly or via separate parallel partnerships which may not meet regulatory definitions of a fund. The asset management entity may hold an interest at AHC level or may invest via a partnership that does not meet the definition for a fund.

2.7 With regard to the asset manager and/or executives, respondents suggested that the level of interest (whether direct, via a fund vehicle or via a limited partnership) may vary considerably between arrangements. Several respondents suggested 25-30% as an upper boundary for such interests, although others indicated that 50% interests were possible in some circumstances.

2.8 Respondents pointed out that carried interest arrangements may mean that the asset manager and/or executives do not receive any returns in respect of their carried interest until the fund reaches a certain hurdle. At this point, they may receive 100% of returns until they have 'caught up' and received a certain proportion of the overall profits. In some periods, this could mean that carried interest holders are entitled to 100% of profits.

2.9 Some respondents highlighted that, in private equity structures, senior executives in portfolio companies may hold interests at AHC level as part of their incentive package. Moreover, investors may invest directly at AHC level in order to hold an interest in a particular element of the overall portfolio – for example, where they are subject to differentiated management fees.

2.10 It was noted that institutional investors may originate their own deals and use AHCs (in which they participate directly) to partner with other investors and/or to ring-fence liabilities and meet security requirements of external lenders. Institutional investors may use wholly-owned corporate or other feeder vehicles to hold their investments, including participating alongside other investors in an AHC. With regard to lending, an institutional investor may set up a separate vehicle to co-lend alongside a fund.

2.11 Respondents noted that it is common for infrastructure and real estate funds to invest alongside a corporate joint venture partner directly into the AHC. The ownership percentage split can vary considerably, although some respondents indicated that corporate operating partners are more likely to hold a small (5% to 10%) stake.

2.12 Some respondents highlighted that large private equity acquisitions may involve a consortium of investors, all participating directly at AHC level. The consortium may typically comprise funds, pension funds, sovereign wealth funds and, in some cases, large corporates.

2.13 Several respondents pointed out that interests held by different investors may change over the life of the investment – with co-investors being brought in to facilitate growth, or as part of a gradual divestment strategy.

Identifying the investors

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?

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?

2.14 Respondents suggested that the regime should treat a range of entities as 'good' investors. Many suggested that the regime set a minimum threshold of 50% ownership of an AHC by 'good investors'.

2.15 Respondents referred to the following investor options:

- Fund vehicles that meet regulatory definitions - most respondents agreed that a requirement that the vehicle be diversely owned or met other relevant tests due to participation by one or more other 'good' investors, was appropriate. Respondents expressed some concerns about potential complexity and suggested possible modifications of existing tests.
- Entities on the Qualifying Institutional Investor (QII) list used for the substantial shareholding exemption and/or the Qualifying Investor (QI) list used for REITs and for non-resident capital gains (NRCG) funds rules - this would encompass pension funds, long-term insurance businesses, sovereign wealth funds and charities.
- Institutional investors who fail to meet or are not included within definitions on the QII and/or QI list, including endowments, overseas registered charities, overseas government bodies and overseas pension funds that do not meet the definition at section 150(1) FA 2004 that is used for the QI and QII lists. Respondents also indicated that there were some difficulties with the definition of a life assurance business used in the QII list.
- REITs and other listed investment vehicles.
- 'Funds of one' and separately managed accounts (SMAs) which will not meet regulatory definitions of a fund – primarily where these are set up between asset managers and institutional investors. Respondents suggested that such investors could be included if the rules provided the option to look through to the institutional investor.

2.16 Some respondents also suggested that the government considers circumstances where diverse investors contract with an asset manager and pool capital directly at the level of the AHC, rather than via a separate fund vehicle - for example, where asset managers operate on a deal-by-deal basis.

Management

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?

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?

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?

2.17 Respondents set out a number of different situations with regard to the asset manager(s) used by investors.

2.18 With regard to fund vehicles used in private equity and real estate funds, respondents agreed that most vehicles that meet the Alternative Investment Fund (AIF) or Collective Investment Scheme (CIS) definitions will use an authorised or regulated manager subject to supervision in their jurisdiction. However, respondents also noted that some funds are self-managed and might fail any tests for independence of management.

2.19 With regard to real estate, respondents expressed concern as to any requirements for a regulated manager and noted that this is not a requirement for REITs or under NRCG rules for collective investment vehicles.

2.20 It was noted that institutional investors may frequently use in-house management who will not be independent or subject to regulation (beyond the regulation applicable to the investor themselves).

2.21 Respondents also pointed out that funds using overseas asset managers may wish to use UK AHCs, and that overseas asset managers will not necessarily be subject to regulation, depending on the jurisdiction in which they operate.

2.22 It was highlighted by some respondents that investors who invest at AHC level will not necessarily access the services of the manager. Although in some cases, the AHC may pay fees or employ asset management executives directly to undertake some management activity, in general, the asset manager(s) will generally be engaged by funds or institutional investors with regard to the larger portfolio of which the AHC investments form a part.

2.23 Operating groups or executives from portfolio companies who participate directly at AHC level will necessarily not be a party to arrangements with the manager(s) and may themselves be actively involved in management and be represented on the board of the AHC.

2.24 Some respondents expressed concern that any test with regard to management should only apply to the relevant entity and that, for example, delegation of some activity to unregulated property managers in a real estate fund would not prevent eligibility.

Character and activities

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

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?

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

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

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

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?

2.25 With regard to the issue of how to exclude or limit trading activity, respondents pointed out that statute does not fully define which types of activities and transactions constitute trading and which do not. In most cases the answer is clear. However, at the margins the position may be unclear, and give rise to uncertainty. Respondents indicated that private equity and credit fund activity in particular might fall into this area of uncertainty.

2.26 Respondents referred to a number of situations where there might be ambiguity as to whether an AHC is trading:

- In private equity, the fund will seek to improve an asset (the portfolio group or company) for sale at a profit. Similarly, distressed debt funds may actively restructure debt. These activities may have characteristics of an adventure in the nature of trade.
- A shorter interval of time between purchase and sale of an asset can be indicative of trading activity. Even where there is a good argument that the intention is to invest, funds may dispose of assets quickly where an advantageous opportunity presents itself or may actively buy and sell debt or equity to maintain the overall value of a portfolio.
- Where a credit fund vehicle engages in direct lending, the origination activity (asset identification, borrower diligence, credit risk management) may amount to a trade.

2.27 If AHC benefits were unavailable to trading activity, some respondents have suggested that they would want guidance to put beyond doubt that various activities would not be considered trading, including direct lending and the acquisition of shares with the intention of sale (possibly after a suitably defined holding period).

2.28 Respondents indicated that they would want AHCs to be able to undertake some trading activity and suggested that certain trading profits could be ring-fenced and excluded from regime benefits. These included:

- Asset management and procurement services, and centralised compliance and treasury functions provided by a holding company and recharged to subsidiaries in the structure, for example to demonstrate substance or aid recovery of VAT;
- Services provided to a portfolio company in a private equity fund; and
- In the case of real estate, property development and buy-and-sell property trading.

2.29 Respondents also suggested that trading profits could be ring-fenced more generally, in order to ensure that AHCs would not become ineligible for the regime in cases where they undertook some trading activity.

2.30 Respondents made various suggestions with regard to possible criteria for the character and activities of the AHC, including:

- No criteria required (possibly with trading activity ring-fenced);
- Requirement that the AHC be an investment company;
- Requirement that the AHC had an investment business of any size;
- Requirement that investment business constituted at least 80% of the AHC's activities;
- Requirement that the AHC be 'established and operated exclusively or almost exclusively to hold assets or invest funds' (borrowing part of the wording used for holding companies of excluded entities in the OECD's Report on the Pillar Two Blueprint);
- Use of an allowable list such as the Investment Transactions List used for various fund vehicles and the Investment Manager Exemption (IME), in order to characterise transactions undertaken in assets such as shares, securities and foreign currency as investment activity;
- Use of the Investment Transactions List subject to a gateway test referring to a purpose of facilitating investments, in line with the consultation document suggestion in relation to investing, investment assets, or acceptable holding company activities; and
- The inclusion of an (unspecified) targeted anti-avoidance test.

2.31 Respondents pointed out that, in practice, most options would still need to rely on the meaning of trade (either directly or by referring to investment). Even in the absence of a specific investment business test, access to any regime exemption for capital gains would depend on an assessment that the disposal was not a trading transaction.

2.32 Respondents did not consider that an AHC regime should require a minimum amount of capital raised for investment and that it would add unnecessary complexity to the eligibility criteria for little benefit.

2.33 Some respondents pointed out that a requirement to have a defined investment policy may result in regulatory consequences. Some real estate strategies choose to use unregulated fund vehicles, but a requirement to have a defined investment strategy could bring the investment arrangements into the scope of regulatory provisions.

Profit on income received by an AHC

2.34 Under current corporation tax rules, in certain situations, the AHC could be subject to tax on varying and significant amounts of profits in accounting periods when investments perform well. In the second-stage consultation, the government explored ways to ensure that any taxable profit recognised by a company choosing to join the AHC regime would be proportionate to its role of facilitating the flow of income and capital between investors and investment assets.

Deductions for payments to investors

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?

2.35 AHCs will typically be funded with some combination of equity and debt. Respondents reported the use of a wide range of instruments including preference shares, income sharing loans, convertible loans and derivatives over equity (for example, warrants or total return swaps). The use of profit participating loans as instruments was reported to be commonplace.

2.36 The use of a specific type of instrument for investments is determined by several factors including the following:

- the risk appetite and investment strategy of the fund;
- legal and accounting factors such as the availability of distributable reserves, which may require interest payments to be made rather than dividends;
- tax treaty and withholding tax implications of interest payments versus dividends;
- various agreements, such as the distribution waterfall and shareholders' agreements;

- banking restrictions, which may for example, prohibit payment of dividends outside of the banking group;
- the ability to repatriate cash flexibly and without the formalities of a share buy-back or distribution, including consideration of capital maintenance rules; and
- the familiarity of investors with various instruments and the mechanics involved, and the impact of personal tax compliance obligations.

2.37 Generally, respondents welcomed a tax deduction for interest on profit or results dependent debt instruments. This would be particularly valuable in situations where it would be difficult to structure back-to-back loan arrangements with broadly matching interest income and expense. Currently, credit fund structures are not generally held through UK companies since profit participating debt is non-deductible.

2.38 To maximise flexibility, it was generally considered that there should be no prescriptive list of specific instruments; rather it should be sufficient that the relevant instrument provides a variable return based on the profits of the AHC.

2.39 In terms of the advantages and disadvantages of allowing a broad range of deductions, it was noted this would largely depend on whether an AHC would be allowed to surrender tax losses as group relief, and what would happen on exit from the regime.

2.40 Respondents considered it unlikely that, based on the government proposals, excessive losses would be generated within an AHC.

2.41 A broader approach could be complex and restrict the ability of AHCs to reinvest income or proceeds from disposals. It could also cause double taxation treaty issues around whether a UK AHC is the beneficial owner of returns.

Transfer pricing

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?

2.42 Respondents generally acknowledged the need to potentially limit deductions in accordance with transfer pricing rules.

2.43 Respondents raised concerns that the application of transfer pricing rules and principles can still cause uncertainty as well as being time consuming and costly. They suggested that the application of transfer pricing rules could be supplemented either by a safe harbour or clear guidance to help reduce the uncertainty.

2.44 Some respondents suggested various approaches to calculating the arm's length pricing and referred to guidance produced by other jurisdictions which has helped reduce uncertainty in the application of transfer pricing rules.

Capital gains realised by an AHC

2.45 In the second-stage consultation, the government proposed that an AHC should not pay tax on capital gains on disposals of investment assets in some situations and under certain conditions.

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?

2.46 Respondents were strongly in favour of a broad and simple exemption for capital gains realised by an AHC.

2.47 It was recognised that profits on disposals of UK land or UK property rich assets should remain taxable but most thought that profits on disposals of overseas property should not be taxed simply because proceeds are repatriated through UK AHCs.

2.48 The majority of respondents were against what they considered to be unnecessary complexity, including any requirement to track or trace gains through investment structures. This would make the regime unattractive as it would increase the complexity of running an AHC structure with additional compliance risks falling on the asset management businesses.

2.49 There was strong recommendation against a deferral regime based on reinvestment/rollover relief as in respondents' opinions this would inevitably be complex.

2.50 The risk of an AHC holding onto cash without reinvesting or returning amounts to investors was considered minimal by the majority of respondents, who pointed out that this would have a detrimental impact on the returns of the fund. Holding onto cash could hinder the raising of further funds and would generally be uncommercial. It was noted that:

- investment decisions ought to be based on market conditions rather than a tax requirement to invest within a certain timeframe;
- there are no distribution or reinvestment conditions in the participation exemptions offered by competitor jurisdictions; and

- if the AHC is required to pass on payments within a certain timeframe, it may not be considered to be the beneficial owner of income and gains for the purpose of double taxation treaties.

2.51 Some respondents considered that stringent eligibility criteria and a targeted anti-avoidance rule could provide safeguards against avoidance concerns. One respondent suggested that the gains of an AHC could be attributed to UK resident investors where they are a participator and hold a certain level of interest and the main purpose, or one of the main purposes, of the arrangement is the avoidance of tax.

2.52 Others considered that individual investors or groups of investors would not have sufficient influence to affect any disposals strategy and the timing of returns of proceeds to all the investors, bearing in mind the fund's distribution waterfall. The gains exemption should therefore not be linked to distributions to investors or the treatment of such distributions in the hands of the investors.

Withholding tax on payments to investors

2.53 The UK tax rules require the deduction of withholding tax (WHT) at a rate of 20% on certain payments of interest. The main circumstances where tax is payable are where a company makes a payment of interest to an individual or other non-corporate person, or where interest is paid by a person (individual, trustee or corporate) to another person whose usual place of abode is outside the UK. In the second stage consultation the government sought to understand if there should be limitations on an exemption through a purpose test or reference to the residence of the recipients.

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?

2.54 All respondents who addressed these questions commented that AHCs should be exempt from the duty to deduct WHT in respect of payments. It was widely commented, as in responses to the first consultation, that many payments obtain relief or an exemption from UK WHT, so the benefit of an exemption would be to remove administrative burdens and costs involved in accessing those reliefs or exemptions. Therefore, placing conditions on such an exemption would not assist with the existing burden that makes the UK unattractive for AHCs.

2.55 Some respondents pointed to the current quoted Eurobond exemption, which permits interest to be paid to investors in any jurisdiction without WHT, and said giving the same effect through this exemption could not increase tax risk.

2.56 Respondents generally did not view the application of a purpose test as a viable option, citing uncertainty as a major concern. A limited number of respondents said that if the government identified an unacceptable level of

risk, providing no exemption to investors located in prescribed countries could be a way to limit an exemption. Other respondents said that limiting an exemption to recipients resident in qualifying territories would create complexity and/or make the exemption inaccessible to, for example, funds of funds or investors participating through such territories. One respondent suggested improvements to facilitate access to existing exemptions using the Double Taxation Treaty Passport (DTTP) register or amending the private placement rules.

Income and gains paid to investors

2.57 In the second-stage consultation, the government proposed that for investors within the scope of UK tax, amounts deducted from taxable income of an AHC and paid to investors would be treated as taxable income, and amounts returned to investors that were attributable to capital gains realised by an AHC would be treated as gains in the hands of those investors.

Income

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

2.58 Respondents observed that, in some cases, existing tax rules would provide the appropriate result. For example, interest payments relating to profit participating loans that are tax deductible for the AHC should be treated as income in the hands of a UK resident investor.

2.59 A few respondents commented specifically on the use of offshore funds rules to protect against manipulation of capital returns. These rules are designed to ensure that, broadly, all returns from an offshore fund are treated as income unless certain conditions are met, in which case investors can treat profits on redemption of their interests as capital. Some suggested using a simplified version of these rules while others were against the use of similar rules and argued against the associated tracking or reporting requirements.

Gains

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

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?

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?

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?

2.60 Most respondents suggested allowing premiums on the repurchase of share capital by an AHC to be treated as capital in the hands of UK individual investors. Currently such premiums are generally treated as income.

2.61 Some respondents also suggested allowing a premium on a repurchase of debt to be treated as capital in the hands of UK individual investors. At present, these are treated as income unless the debt qualifies as an excluded indexed security (EIS) for which the return tracks a chargeable asset or assets.

2.62 Others suggested it should be possible to characterise payments from AHCs as capital in the hands of UK investors generally, so far as such payments are not attributable to underlying income.

2.63 Respondents largely viewed a tracking system, as proposed in the consultation, to be unworkable due to the potential complexity of AHC structures and uncompetitive in comparison to offshore arrangements where the compliance burden is much lighter.

Gains: anti-avoidance

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 against conversion of income to capital?

2.64 A few respondents noted that some investment structures may have few or no UK individual investors and thus the risks of income to capital conversion are low, and that the need to consider the tax position of such investors should not create significant additional cost or administrative requirements for the AHC. However, as is common with alternative investment strategies, fund executives are likely to hold interests directly or indirectly in the investment arrangements and receive returns from those interests.

2.65 Some respondents suggested that existing rules targeted at fund executives could protect against potential abuse. However, others recognised that existing rules are only in in relation to asset manager remuneration, such as disguised investment management fees and carried interest, so could not offer protection.

2.66 Many respondents thought that some form of targeted anti-abuse rule may be appropriate – for example, purpose-based, or a requirement for general assurance that amounts are appropriate and proportionate. A few others thought that some form of tracking or streaming could be used to determine appropriate amounts as long as any system was simple.

Gains: loan relationships

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?

2.67 Responses were varied but broadly made the point that the rules should allow the AHC to pay tax on an appropriate margin. Where gains are taxed, this will therefore require a deduction when the gain is passed back to the investor.

2.68 If certain amounts arising in the AHC were to be treated as capital, the Investment Association's Statement of Recommended Practice (IA SORP) was suggested as a method to distinguish between income and capital amounts.

Real estate

2.69 In the second-stage consultation, the government asked questions to understand how suitable the AHC regime would be to funds that hold real estate in multiple countries.

Multi-jurisdiction real estate funds

Question 32: Can you provide evidence on the number and type of situations where a fund might wish to use UK SPVs to own and receive overseas property income directly?

Question 33: Given the availability of relief in the UK for foreign tax paid, to what extent would the lack of an exemption for overseas property income act as a barrier to the use of UK AHCs to hold overseas property? Can you provide any examples of specific situations affected by this issue? To what extent would this affect the choice to locate master and intermediate holding companies in multi-jurisdictional real estate funds in the UK?

2.70 Respondents noted that overseas real estate is generally held in local special purpose vehicles (SPVs) and it is not currently common for funds to hold overseas real estate in a UK SPV, though this could become more common in the future if the UK AHC regime makes it a viable option.

2.71 The credit relief mechanism is not considered to be a viable option as some respondents said that it leads to a lack of certainty over the level of UK tax that will be suffered, as well as adding complexity and compliance costs. One respondent said that an AHC regime which relied on the credit relief method would be unlikely to be used to any real extent.

2.72 Respondents explained that in the majority of cases, property income will have been taxed in the jurisdiction where the real estate is situated, therefore it would not be appropriate for further tax to be charged in the UK on that income. A risk of additional UK tax would make it unlikely that a UK resident AHC would be used to hold overseas real estate investments.

UK property

Question 34: To protect against the risk of loss of tax on UK property income and gains, do you think it would be appropriate for regime rules to specify that an AHC should not own UK land or UK property rich assets? To what extent could this discourage use of AHCs for multi-jurisdictional real estate funds?

Question 35: If the regime permitted AHCs to own UK land and UK property rich assets, how could rules ensure that the additional deductions and reliefs available to an AHC did not lead to any erosion of the UK tax base in UK property?

2.73 Most respondents thought if the AHC could not own UK property, both directly and indirectly, the viability of the AHC regime would be jeopardised because UK property is a major investment class in pan-European and Global real estate funds. For instance, funds would need to introduce a 'corporate

blocker' between income or gains from tax transparent entities holding UK property; there would be a lack of commercial flexibility if UK property had to be avoided; and it would be difficult to achieve tax neutrality when repatriating returns from non-AHC SPVs holding UK property.

2.74 Respondents suggested that if a UK AHC is permitted to own UK property, it would be important for investors to be in no worse a position than they would be if they held the UK property directly or via a non-UK vehicle, although it was recognised that the UK's taxing rights in relation to UK property could not be eroded.

2.75 Respondents thought that with appropriate safeguards, it would be possible to protect against the loss of tax on UK property income and gains. It was recognised that this could create unavoidable additional complexity since there would need to be some element of 'ring-fencing' so that UK property could remain taxable and could not be offset against any additional tax deductions provided under the AHC regime, such as payments under profit participating instruments.

Stamp duty and SDRT

2.76 The second-stage consultation sought views on the impact of Stamp Duty and Stamp Duty Reserve Tax (SDRT) on AHC location with particular reference to the effect of charges on the transfer of shares issued by an AHC (including situations where an AHC repurchases its own shares) and issues around availability of the Stamp Duty loan capital exemption.

Question 36: How significant is the impact of Stamp Duty and SDRT on AHC location, in particular with reference to the points listed at paragraph 4.134? Please provide details of the specific situations where the lack of an exemption would have a significant impact when deciding whether to locate an AHC in the UK.

2.77 Most respondents would prefer a general exemption for the transfer of securities issued by an AHC, particularly share and loan capital. However, the majority also thought that it was most important that exemption was provided in respect of the re-purchase by an AHC of shares which it had previously issued.

2.78 Respondents indicated that Stamp Duty and SDRT are likely to be factored into broader costs and considerations when assessing suitable AHC locations and that the impact would depend on the role of the AHC and the methods used to return capital to investors. Some respondents thought that Stamp Duty and SDRT should not impact heavily on the choice of AHC location or that the stamps costs could be worked around.

2.79 The main competitor jurisdiction discussed by respondents was Luxembourg. Respondents pointed out that transactions in shares and other securities in Luxembourg companies are not subject to Luxembourg transaction taxes equivalent to the Stamp Duty and SDRT charged in the UK.

2.80 Some respondents mentioned that new holding companies that are set up in the UK to make use of the AHC regime instead of a competitor jurisdiction will not result in an Exchequer cost. This is because at present a non-UK incorporated company would be used to prevent a Stamp Duty or SDRT

charge arising. They mentioned that if an exemption is not granted, it would be possible to establish a non-UK incorporated, UK tax resident company with a share register maintained outside the UK, that would permit access to the UK AHC regime generally while permitting shares and other interests in that non-UK incorporated company to be transferred without Stamp Duty or SDRT.

2.81 Difficulties around the loan capital exemption were mentioned by a number of respondents. The transfer of loan capital is generally exempt from Stamp Duty (and therefore SDRT) under the loan capital exemption. There is an exception to this for loan capital which is in some way equity-related. For example, exemption will not apply where the loan capital carries a return linked to the profitability of the company or value of any of the property, the interest exceeds a commercial rate of return, or the loan capital carries conversion rights. Respondents mentioned that many loans issued by AHCs can contain one of these features particularly in loans issued by credit funds.

2.82 Some respondents mentioned that an AHC may repurchase the loan capital it has issued as a method of returning capital to investors, therefore exemption should cover the repurchase of an AHC's own loan capital as well as share capital.

2.83 A few respondents suggested that the acquisition of securities by an AHC should be exempted. Other respondents thought this unnecessary as Stamp Duty or SDRT would be payable on the acquisitions of assets by the relevant vehicle in any event (irrespective of location of the AHC).

Hybrid mismatches

2.84 A number of respondents raised the issue of the interaction between hybrid mismatch rules and the proposed AHC regime. In particular, respondents thought that any tax exemptions offered by the AHC regime had the potential to generate mismatches which may fall within the scope of the hybrid mismatch rules. The absence of any clear rules governing the interaction between the two regimes would generate significant uncertainty and may also impose a significant compliance burden on the AHCs themselves.

Corporate groups

2.85 In the second-stage consultation, the government suggested that an AHC should not be able to surrender or claim losses as group relief given the additional deductions and reliefs allowed for an AHC and its status as part of an investment fund structure.

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

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

2.86 Respondents generally considered that the approach on group relief and other grouping issues should be consistent with the taxation mechanism adopted for AHCs. Thus, it may be appropriate to ring-fence AHCs in some

circumstances, but in others it may be appropriate to treat AHCs as part of the wider group.

2.87 Where a structure involves multiple stacks of AHCs, it was noted that the ability to use group relief between AHCs within the same structure would be required to avoid unnecessary additional tax between the underlying investment assets and the investors.

2.88 Respondents reported the need to consider other group rules, such as the corporate interest restriction and the intragroup transfer rules in TCGA 1992.

2.89 Some respondents thought that the capital gains tax reorganisation rules should apply to prevent tax charges arising that would not arise if the reorganisation had been undertaken using group companies that are not AHCs.

Entry and exit from the regime

2.90 The second-stage consultation sought to gauge the need for existing companies to be able to gain access to the regime. It is also necessary to consider rules for the taxation of assets as they enter and exit the regime. Prevention of amounts falling out of scope of tax is a key concern in the case of established companies that may already have assets with accrued gains prior to joining the regime. Other concerns, such as the treatment of losses and the liquidation of an AHC, must also be considered.

2.91 It is recognised that companies could unintentionally breach eligibility criteria and the second consultation sought to understand how widespread this issue could be and how it may be managed.

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?

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?

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?

2.92 All respondents who addressed these questions advised that the AHC regime should accommodate entry for already existing holding companies, with some respondents claiming that it would be unfair to disadvantage funds who have already set up companies as UK AHCs by excluding them from the regime. Some respondents stated that there should be no tax charge on entry for the company joining the scheme or investors in such companies as this will disincentivise take-up.

2.93 Further concern was raised that if the consideration of the Substantial Shareholdings Exemption (SSE) 12-month rule was made at time of entry

then this would unfairly disadvantage companies who have only recently acquired assets.

2.94 The treatment of existing losses being brought forward into the regime was mentioned by a couple of respondents. One advised that tax losses available prior to joining the regime should no longer be available whereas another requested that brought forward losses be frozen at point of entry and become available again at point of exit.

2.95 Most respondents agreed that assets should be able to access regime benefits for the period of AHC membership only.

2.96 On exit, respondents agreed that assets should be rebased to market value.

2.97 Non-chargeable assets such as loan relationships and derivatives should not be impacted at time of exit as they do not have access to exemption from tax within the AHC. Other benefits such as withholding tax and stamp duty are based on payments and transfers, so it would be expected that these would simply no longer apply from date of exit.

2.98 Most respondents raised concerns that no untaxed profits or gains should be passed to investors at point of exit as this could create a double tax charge when fund assets are finally disposed of.

2.99 A common theme in responses was that operators of AHCs should be able to easily assess that from the outset they can continue to meet the eligibility requirements over the life of the AHC. Concern was raised in relation to unnecessary tax consequences or continuing obligations for non-AHC purchasers of AHCs as this would make the transaction unattractive and could impede genuine commercial activity.

2.100 A few respondents stressed that as long as the eligibility criteria are simple and clear then it would be unlikely that a company would be wound up and subsequently be found not to have met eligibility criteria. If the government considered that some protections were required, then the circumstances in which a post winding up charge could apply should be clear as it could affect take-up if unexpected tax liabilities were charged to fund's investors after the winding up of an AHC. Further to this, tax should only be recoverable where there has been fraudulent or negligent activity.

2.101 Other respondents advised that there are already established procedures in place to deal with winding up scenarios and therefore no further provisions need to be put in place.

2.102 A few respondents suggested that AHCs should be required to obtain HMRC clearance before being wound up in order to confirm that eligibility criteria have been met, to give a level of assurance that HMRC would not open enquiries into the final return that could lead to the need to pursue recovery from investors.

Accounting periods

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

2.103 Most respondents agreed that a new accounting period (AP) should start when a company enters and exits the regime with some respondents advising that a new AP would be helpful to ring-fence the application of the provisions of the regime at points of entry and exit.

2.104 It could be more appropriate to have a notional AP on entry and exit so as to avoid unnecessary divergence from the period in which the accounts are drawn up.

Temporary breaches

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?

2.105 Most respondents mentioned that if eligibility criteria are broad and straightforward then the circumstances where an AHC ceases to qualify temporarily will be limited.

2.106 It was generally felt that there should not be a 'cliff edge' where AHC status can be lost. Minor breaches should not result in loss of AHC status unless they were repeatedly made. If consequences are too severe then this will affect take-up.

2.107 Examples of times where eligibility criteria may temporarily be breached included a change of investors, where a fund no longer qualifies as an AIF or CIS, or where an AHC is sold to a non-qualifying investor. Respondents requested that, in such instances, an AHC should be given a grace period within which to take steps to meet eligibility criteria.

Other tax issues

2.108 Respondents provided comments on a range of other tax issues that they suggested should be considered when designing the new regime as well as sharing information on how overseas companies are used as AHCs in investment structures.

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.

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

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?

2.109 Responses in respect of the controlled foreign companies (CFC) rules were split. Some said that a requirement to comply with CFC rules does not damage UK competitiveness and nor do these rules represent a barrier to establishment in the UK, particularly when OECD BEPS initiatives mean other jurisdictions have similar rules in place. Others requested an exemption from

the CFC rules on the basis that often no CFC position exists, therefore the compliance burden outweighs the risk. One respondent suggested that a purpose based anti-avoidance provision could be coupled with an exemption to dissuade UK investors establishing a UK AHC to solely to avoid a UK CFC charge. Other respondents said they would welcome simplification to the CFC rules specifically tailored to AHCs.

2.110 Some respondents considered that many groups are familiar with the Corporate Interest Restriction (CIR) and that EU countries have implemented the Anti-Tax Avoidance Directive (ATAD) with broadly similar provisions. Some respondents pointed out circumstances where there may be some further considerations to their application, particularly where the structuring of the investment arrangements relies on existing group relief rules. One respondent suggested that each AHC should be considered a 'single worldwide group'.

2.111 Respondents made the point that the AHC should be able to set fair value movements that arise on debt financing against fair value movements on acquired debt.

2.112 Some respondents raised concerns about the taxation of derivatives, including deal-contingent forward currency contracts, used to hedge foreign currency risk on acquisitions and disposals of shareholdings. Under current legislation, profits or losses on such derivatives are taken into account as income items during the lifetime of the instrument. This gives rise to a mismatch with the tax treatment of the shares, which will not be taxed or relieved until the shares are ultimately disposed of, or may alternatively be covered by the substantial shareholdings exemption (SSE).

2.113 Respondents suggested that exemptions from corporation tax available for distributions should be available for AHCs. A few suggested extending the large company and small company exemptions to an AHC.

2.114 One respondent suggested that it may be appropriate for AHCs to not be qualifying companies for the purpose of the Senior Accounting Office to align with the treatment for non-UK AHCs who are outside of the regime.

2.115 Some respondents expressed uncertainty around the application of the employment related securities (ERS) rules to individuals who will receive carried interest as part of their investment management remuneration arrangements. Others considered that holding a directorship in an AHC should not impact upon the tax treatment of carried interest receipts; if it did, there may be greater access to exemptions within the income based carried interest rules for ERS which would be against the purpose of those rules.

2.116 A few respondents also discussed how the personal tax implications for those who are non-UK domiciled or non-resident are major considerations when determining where an investment structure locates its AHCs. Some of these respondents suggested that use of UK AHCs should not create remittances to the UK and a small number suggested that interests in AHCs should not be UK situs assets for inheritance tax purposes.

Anti-avoidance

2.117 The government is seeking to protect any new AHC regime from risks of abuse or avoidance.

Question 47: 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.

2.118 Several respondents expressed the view that an AHC regime with suitable entry and qualification requirements may not require any specific anti-avoidance rules.

2.119 Other respondents acknowledged that anti-avoidance rules may be necessary in order to ensure that the regime operates as intended, and in order to minimise the opportunities for abuse. However, respondents also indicated that any such anti-avoidance rules should be sufficiently narrow and limited in scope so as to protect the regime without introducing uncertainty or an increased compliance burden, both of which would significantly reduce the overall attractiveness of the new regime to investors and fund managers.

Reporting and monitoring

2.120 The government is considering how to monitor the regime effectively and is seeking to understand what information would be required.

Question 48: 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?

Question 49: 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?

2.121 Most respondents advised that if reporting requirements are too onerous, this will have a negative effect on take-up. Information should not be asked for if it is already available in the company accounts.

2.122 Some respondents suggested that it would be reasonable for standing information to be provided such as, date of joining the regime, identification of the fund manager, confirmation of how eligibility criteria are met.

2.123 Others warned that the additional tax compliance required to track gains and income repatriated to investors or carrying out detailed calculations about the underlying portfolio would affect regime take-up.

2.124 Some respondents advised that the information in paragraph 4.156 of the second consultation paper is extensive and if provided, should ensure that the AHC is perceived by HMRC to carry a low non-compliance risk. Others suggested that some of the information (value of portfolio at most recent valuation, proportion of portfolio comprising assets situated outside of the UK, proportion of income received in the AP arising from sources outside the UK and gains re-invested since joining the regime) is either unnecessary or could be found in the company accounts.

2.125 A couple of respondents advised that this level of information is not required in competitor jurisdictions and therefore any onerous requests would make the UK less attractive.

2.126 One respondent advised that XBRL should provide HMRC with the ability to flag eligibility breaches which should, in a timely manner, help with AHC and investor certainty over their tax position and make it easier for the AHC to be successfully marketed.

2.127 It was suggested that, in order to drive consistency, a standard return form / attachment could be developed.

Section Two: changes to the REIT regime

2.128 While a comprehensive review of the REIT rules is intended to form part of the wider funds review, responses to the original consultation suggested that there are a number of changes that could be made alongside the introduction of the AHC rules that would have immediate benefits in making the UK a more competitive location for holding real estate assets. The second-stage consultation explored the potential for such changes and asked a number of further questions on the areas set out below.

Listing requirement

2.129 The 'listing requirement' refers to the requirement that the shares in a REIT are to be admitted to trading on a recognised stock exchange. Many responses to the first consultation suggested that the requirement can lead to increased expense and administration, and that it was not clear what function the listing requirement served, in particular where a REIT is substantially owned by one or more institutional investors. The second stage consultation explored possible reforms.

Question 50: Who should any relaxation of the listing requirement apply to? If there is a relaxation for institutional investors, how could this be applied? What are the benefits and risks of applying a relaxation where institutional investors hold less than 100% of the REIT and where should any cut off point be set if relaxing the requirement for REITs only partly held by institutional investors?

Question 51: What would be the benefits and risks of a complete removal of the requirement for listing?

2.130 Responses largely reinforced the comments made by stakeholders in response to the first consultation. Many responses suggested that the listing requirement was superfluous following amendments to facilitate ownership by institutional investors in 2012, the view being that the non-close test and anti-avoidance provisions give adequate protection for investors. One respondent favoured a complete removal of the requirement.

2.131 An alternate view was put forward by two respondents suggesting that all REITs should remain listed. Their view is that listing is an important part of the REITs 'brand'. These respondents also consider that listing is required for the benefit of efficient capital raising and liquidity, although a number of

other respondents have noted that institutional investor owned REITs do not raise capital on public markets.

2.132 Some respondents suggested that the cut-off point for listing could be linked to the close company relaxation. Others suggested a specific threshold, ranging from 50% to 100% held by institutional investors. It was noted that a 100% holding requirement would exclude cases where fund managers hold minority interests. Some respondents also suggested the introduction of a transitional rule to allow time to list after a change of ownership such that the minimum requirement with regard to institutional investors was no longer met.

Institutional investors and the close company requirement

2.133 To qualify as a REIT a company must, among other things, meet the condition that it must not a close company, unless it is a close company only because it has as a participator an "institutional investor" as defined in the REIT rules. The second-stage consultation noted that the government would explore options for reform, including additions to the list of institutional investors, a 'look through' test similar to that in Schedule 5AAA TCGA 1992 to determine whether a company is close, and reconsidering how the UK REIT equivalent test might be met.

Question 52: Are there any further investor groups who should be added to the list of institutional investors? Why should these investors be added, including the expected impact and are there any additional tax issues that would need to be considered?

Question 53: When considering a look through approach as part of the close company test, should this work in a similar way to the NRCGT rules or would this need to be modified to work with the REIT rules? If the rules would need to be modified, what changes should be made?

Question 54: Would a change to the rules for overseas equivalents of a REIT encourage overseas investment through UK REITs? What difficulties may there be in establishing that an overseas company satisfies the requirement to be equivalent? Are there any risks arising from such a change?

2.134 Respondents were in support of introducing a close company 'look through' approach similar to that used in Schedule 5AAA TCGA 1992 (non-resident gains: collective investment vehicles (CIVs)) and proposed the repeal of section 528(5) CTA 2010 which switches off, for the purposes of the REIT rules, some of the exemptions in the definition of close companies.

2.135 Respondents suggested a range of other investors they considered should be added to the list of institutional investors. These included: a CIV which has elected to be exempt from non-resident capital gains tax; overseas government bodies or wholly owned bodies of overseas governments; non-UK charities and endowments; authorised contractual schemes; overseas pension funds; and subsidiaries of overseas REITs. Further suggestions were made regarding having a 'principles based' category and obtaining clearance from HMRC that particular entities would qualify.

2.136 Respondents generally agreed with changing the rules for overseas equivalents of a REIT so that the entity should be equivalent to a UK REIT, rather than the overseas regime being equivalent to the UK REIT regime. A number of responses suggested that an overseas entity should be treated as equivalent if it has the broad characteristics described in the OECD Commentary on Article 10 of the model treaty ('A REIT may be loosely described as a widely held company, trust or contractual or fiduciary arrangement that derives its income primarily from long-term investment in immovable property, distributes most of that income annually and does not pay income tax on the income related to immovable property that is so distributed.').

Holders of excessive rights rule

2.137 A holder of excessive rights is defined as being a person who is beneficially entitled to at least 10% of the distributions, at least 10% of the share capital or controls at least 10% of the voting rights. A charge may be triggered in certain cases where a REIT makes a distribution to a holder of excessive rights. The intent of this rule is to ensure profits from UK property are taxed in situations where the UK's treaty obligations prevent withholding of tax on distributions. Respondents to the original consultation generally noted that the rule often led to the creation of complicated and costly structures solely to remain under the 10% limit, even where the investors in question are entitled to receive gross property investment distributions. The government responded that it would consider reforms so that the rule would apply only on distributions to entities where withholding tax is required.

Question 55: Are there any different ways in which this rule could be changed that should be considered? If so, please explain how, the reasons for such changes, and identify the impacts and risk.

2.138 Respondents generally agreed that those who can receive a property income distribution without deduction of withholding tax should be excluded from the holders of excessive rights charge.

2.139 Some respondents suggested that the exclusion from the charge should be related to investors who would not benefit from a lower rate of withholding tax by virtue of the size of their holding as a result of a double taxation treaty.

2.140 Suggestions were also made regarding changes to the list of investors who can receive a property income distribution without deduction of withholding tax. These included sovereign immune entities and overseas pension funds as well as a look through approach for partnerships.

The balance of business test

2.141 The balance of business test was introduced to ensure the focus of a REIT was on holding and managing property, while recognising that it might undertake some ancillary activities. The rules are contained in section 531 (assets and income tests) and section 532 (provision of financial statements) CTA 2010.

2.142 Responses to the first consultation generally noted that the operation of the rule was problematic and, in some instances, unduly burdensome due to industry developments since the introduction of the rule. In particular, it was noted that requirements to develop affordable housing or infrastructure as part of section 106 of the Town and Country Planning Act 1990 (TCPA 1990) planning obligations often led to uncertainty as to how the test should be applied and the risk that a breach of the conditions could potentially occur. The preparation of financial statements was also said to impose an unnecessary burden on REIT groups that carry out very little ancillary activity.

2.143 The second-stage consultation set out a number of suggestions as to how the rule could be reformed.

Question 56: Which of the reforms suggested, or combinations of them should be considered? Are there any other ways in which the balance of business rules could be reformed in order to reduce burdens while maintaining the principles of the REIT regime? How might these apply in practice?

2.144 Most respondents re-emphasised comments made following the original consultation that preparation of financial statements imposes a significant administrative burden on REITs which is unnecessary where a REIT undertakes very little residual activity.

2.145 Another general theme was that the environment for property development has changed, and planning permission now more often than not includes a requirement to provide residential property or other services. This can lead to failure of the balance of business test, or uncertainty as to whether it is met. Those that made this point suggested that activity to meet such requirements should not be allocated to residual business when applying the balance of business test.

2.146 Some respondents suggested using a 3-year average in the case of a REIT that otherwise fails to pass the test, and that a breach of the test (or part of the test) should be ignored for one or more initial accounting periods. One respondent noted that this could add further uncertainty.

2.147 Respondents were generally cautious on excluding overseas property holdings from the balance of business test to attract more pan-European REITs because, as noted in the original consultation, this could have a positive or negative impact depending on the circumstances; some respondents said that it should be possible to elect for overseas property to be ignored for the purposes of the test.

Chapter 3
Government Response

3.1 Following careful consideration of all the responses to the second-stage consultation, the government is now outlining its intention for the final shape of the AHCs regime to be implemented from tax year 2022/23. It is also confirming the complementary changes to the REITs regime that will be taken forward to the same timetable. This is set out below and alongside this document, the government is publishing draft clauses covering various aspects of the regime.

3.2 In each case, the government has been mindful of a number of factors in its decision making. These include, though are not limited to:

- the overall objectives of the measure, in the context of the wider review of the funds regime;
- ensuring the regime is sufficiently attractive compared to those in overseas hubs;
- the anticipated Exchequer impact;
- tax avoidance risks; and
- full adherence to the UK's international commitments and tax standards.

The government believes that the regime envisaged strikes the optimal balance across each of these areas and will build significantly on the UK's strengths as an asset management hub.

Eligibility

General

3.3 The government recognises that a clear and effective set of eligibility criteria is key to the successful operation of an AHC regime. To qualify, a UK resident company must meet a set of conditions and elect for the regime to apply. Such companies are referred to in this section as Qualifying Asset Holding Companies or QAHCs.

3.4 The eligibility tests should be applied on an ongoing basis. If at any point in time, they cease to be met by a QAHC, the company will cease to be a QAHC with effect from the point in time when the tests cease to be met unless a specific rule applies – see below.

3.5 The government recognises that, in the early life of a fund in particular, there may be a desire to include a QAHC in a structure at a point when the eligibility criteria are not yet met but are intended and expected to be met. In

such cases it may be appropriate to permit a company to become a QAHC in anticipation of its meeting the tests. The government will consider further how to achieve sufficient commercial certainty for investors in such cases without giving rise to unacceptable Exchequer risks.

3.6 Similarly, the government recognises that not all breaches of the eligibility criteria should necessarily lead to loss of QAHC status. Where a breach is minor or is temporary, and is resolved, loss of QAHC status could often be a disproportionate outcome. This issue is discussed further below.

Ownership

3.7 The government acknowledges the range of views expressed by respondents and agrees with the general view that QAHCs should be available to a wide range of investors. It is proposed that eligible investors (referred to in this document as category A investors) should fall within two main categories, as follows:

- Diversely owned, eligible funds with regulated managers; and
- Certain institutional investors, many of which are themselves regulated for financial services purposes.

Investors who are not category A investors are referred to as category B investors.

3.8 The government considers that a person or entity making investments via a QAHC will be a person who has an interest in and participates in the results of investment assets that the QAHC acquires. Advancing a loan at a fixed rate of interest to a QAHC on arm's length terms will not mean that a person is investing via the QAHC, since they will simply receive a fixed, commercial return on a loan. However, a person who advances a loan to a QAHC and receives a variable rate of return depending on the results of the investments will generally be considered to be making investments via the QAHC.

3.9 The definition of eligible funds will be based on the existing Collective Investment Scheme (CIS) and Alternative Investment Fund (AIF) rules[1].

3.10 Diversity of ownership conditions will be based on the genuine diversity of ownership (GDO) rules in the Offshore Funds (Tax) Regulations 2009[2] and, in relation to companies and listed funds, the non-closeness concepts applied in TCGA 1992[3], , the UK REITs rules and the Investment Trust (Approved Company) (Tax) Regulations[4].

Regulated managers

3.11 The government intends that where funds are required to have a regulated fund manager to meet regulatory requirements, that manager must be independent. The government is exploring how to deal with situations where

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1 These are used in Schedule 5AAA TCGA 1992

2 SI 2009/3001

3 Schedule 5AAA TCGA 1992

4 SI 2011/2999

funds do not have managers but would be required to do so by UK law if the fund were marketed here or otherwise had a connection to the UK. It is not anticipated that QAHCs owned by institutional investors will be required to employ the services of an independent and regulated fund manager.

Institutional investors

3.12 The intention is to use the qualifying institutional investor (QII) lists for substantial shareholdings exemption (SSE) and the qualifying investor (QI) list for REITS and non-resident chargeable gains (NRCG) funds as the basis for the AHC institutional investor requirements. These lists will be adjusted for the purposes of the AHC regime – excluding, for example, social landlords from the QI list.

3.13 UK REITS will qualify as category A investors for the purposes of the AHC regime. Overseas REITs may also qualify as category A investors, subject to the application of the approach used in the non-resident capital gains rules[5].

3.14 The following entities will be treated as category A investors, based on the QI list:

- Widely held pension funds;
- Long-term life assurance business entities;
- Persons not liable to UK tax due to sovereign immunity; and
- REITs (UK and equivalent overseas REITs).

Ownership proportions

3.15 Following careful consideration, the government is proposing that the ownership rules require a minimum 70% holding by category A investors. The ownership rules will allow direct investment in a QAHC, or indirect investment via another QAHC – enabling a chain of QAHCs to be set up where necessary. Entities which are essentially wholly owned by category A investors will also qualify as category A investors if they are not QAHCs, subject to a non-trading criterion.

3.16 While the government notes that some respondents suggested that category B investors should be permitted to hold up to 50% of a QAHC, the government has decided to set a 30% limit on such investors to mitigate the Exchequer risk of an unintended policy outcome where QAHCs could be utilised in situations where a category B investor has substantial influence over an AHC.

3.17 The government acknowledges that an AHC's capital structure will often involve a range of different interests – including equity, profit participating loans and vanilla debt. In addition, such interests could derive their value from the total asset base of an AHC or from specific subsets of the AHC's asset base. As mentioned earlier in this response, a person or entity holding

[5] Sch 5AAA TCGA 1992

vanilla debt with no equity like features would not be regarded as an investor in a QAHC for the purposes of the relevant tests.

3.18 The investment/ownership rules will also have to deal with any rights to receive carried interest held by either investment management entities or individuals involved in fund management (fund executives). These may arise from interests in the AHC itself or interests in a fund which is an investor in the AHC. Carried interest entitlements in a fund which is an investor in an AHC will not be relevant to the calculation if that fund is a category A investor, other than in the specific circumstance referred to below.

3.19 Individual fund managers with direct interests in the AHC (or interests in the AHC held via a collective vehicle such as a carried interest partnership) will be category B investors, whether those interests are in the nature of carried interest or co-investment. In determining ownership proportions, carried interest holders will be assumed to hold their maximum eventual share of profits at all times (both directly via the AHC and, where relevant due to the operation of the rule referred to below via any fund which is an investor in the AHC). This will prevent holders of 'catch-up' carried interest from being treated as holding extremely large total shares during any period in which their carried interest is catching up.

3.20 Where an investor holds a direct stake in a QAHC, the amount of that stake must be aggregated with any indirect interest held by that investor (or their connected persons) via a fund which is also an investor in that QAHC.

3.21 The draft legislation will include investment (or ownership) tests based on the consortium relief rules[6]. The AHC rules will test investment interests by voting rights, entitlement to distributions, and the rights to assets in the event of winding up. With regard to category A investors, the lowest of these three measures will be used; with regard to category B investors, the highest of these three measures will be used.

3.22 Where the capital structure of an AHC does not confer equal pro rata interests in all activities of that AHC (for instance because a particular class of shares responds only to the performance of a specific asset of the AHC), the percentage ownership tests must be satisfied by reference to each category of assets/profits of the AHC which are treated in a non-pro rata way within the capital structure.

AHC role and activities

3.23 The government considers that to be eligible, all or substantially all of the activity of an AHC should be investment activity. The government will continue to consider whether it would be appropriate to include a test of purpose in order to reflect the policy intention that QAHCs should be companies that have been established with a purpose of making, holding, managing and disposing of investments with a view to generating returns for eligible investors.

3.24 However, not all investment activity will qualify for regime benefits. Investment in certain assets (shares, overseas real estate and creditor

6 Section 143 CTA 2010

relationships) will qualify for regime benefits and is therefore referred to as 'qualifying' activities. All other activities will be 'non-qualifying', such as investing in UK real estate (directly or indirectly) or intangibles (to the extent not related to overseas real estate), and trading activity (which is in any event required to be minimal). It will not be necessary for any specific proportion of a QAHC's investment activity to be qualifying activity (so, for instance, a QAHC could hold a material amount of UK real estate as an investment – this would be non-qualifying investment activity).

3.25 Respondents have indicated that AHCs are unlikely to be engaging in activity in the nature of a trade to any material extent. That said, it has also been noted that there can be uncertainties in the application of the tests of trading in existing law in specific situations. The government therefore intends to continue engagement with a view to determining a test of investment activity which offers greater certainty than existing law whilst adequately mitigating the risk that some activity properly regarded as trading might access regime benefits.

Minimum amount of capital raised for investment

3.26 The government is considering whether it would be appropriate to set a requirement for a minimum amount of capital raised for investment (which could include debt funding), in the region of £50m to £100m, as an eligibility requirement for QAHCs.

Listed companies and real estate investment trusts

3.27 Listed companies will be excluded from being QAHCs. This is not expected to be a practical constraint.

3.28 It will not possible for a company to be both a REIT and a QAHC.

Taxable profit of QAHC

3.29 The government intends that the taxation of a QAHC is to be based on existing corporation tax rules, but with certain amendments to ensure most income and gains can be returned to investors with little or no tax paid by the QAHC. This is in line with the principle that the investors are to be taxed on these amounts in their jurisdiction of residence as appropriate, and that the tax paid by the QAHC should not exceed an amount that is proportionate to the value of the activity it undertakes.

Loan relationships and derivatives

3.30 The government intends that the taxation of the QAHC will be based on its commercial margin, adjusted if necessary in accordance with the transfer pricing rules, measured on an accruals basis. To allow this, the government is proposing to switch off the late paid interest rules in their application to the qualifying activities of QAHCs.

3.31 In addition, certain distribution rules in respect of profit participating loans and results-dependent debt will be switched off in relation to the qualifying

activities of QAHCs[7]. The QAHC would thus have an allowable deduction under the loan relationship rules. This treatment should follow through to the holder of the debt instrument such that where the investor is a UK corporate entity, the payment will be taxed as a loan relationship credit. For individual investors, the payments would be treated as income or in some cases, where the debt is structured as an excluded indexed security (EIS), the payments could be capital.

3.32 One further issue raised in the second-stage consultation responses was the taxation of derivatives, including deal-contingent forward currency contracts, used to hedge foreign currency risk on acquisitions and disposals of substantial shareholdings. Under current legislation, profits and losses on such derivatives are taken into account as income items during the lifetime of the instrument. This gives rise to a mismatch with the tax treatment of the shares, which will not be taxed or relieved until the shares are ultimately disposed of or may alternatively be covered by the substantial shareholdings exemption (SSE).

3.33 The government is examining the possibility of legislating to ensure that the treatment of gains and losses on the hedging instrument are aligned with the treatment of the shares (the hedged item). This would need secondary legislation to amend regulations[8], which would apply to all companies, not just QAHCs. The government will continue to take account of the views of stakeholders on this matter.

Withholding tax

3.34 As noted in the response to the first consultation, the government does not propose to make any general relaxation of the duty to deduct withholding tax (WHT) from interest. However, the government acknowledges that there are already broad and widely used exemptions in respect of WHT and recognises that obtaining such exemptions creates burdens that are not present in other jurisdictions where AHCs are commonly located.

3.35 Therefore, the government intends to remove the obligation to withhold a sum representing income tax in relation to payments made in respect of securities held by investors in a QAHC.

Real estate

UK real estate

3.36 The government intends to permit QAHCs to directly and indirectly hold UK real estate. However, UK real estate income and gains on disposals will be subject to corporation tax in the usual way. Thus, net rental income (after deducting the usual allowable expenses such as agent fees and interest expenses) will be subject to corporation tax. The distribution and late-paid interest rules will apply as normal. Any gains on disposals of UK property or land will be chargeable to corporation tax.

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[7] Specifically, condition C of section 1015 (results dependency) CTA 2010 will be switched off where the company making a payment is a QAHC

[8] Disregard Regulations (SI2004/3256) and the EGLBAGL Regulations (SI 2002/1970)

Overseas real estate

3.37 In line with the views of the majority of respondents, the profits of an overseas property business of a UK resident QAHC will be exempted from corporation tax, where those same profits are subject to tax in an overseas jurisdiction.

Chargeable gains

3.38 The government is proposing an exemption for gains on chargeable assets that are commonly held by AHCs, that is most shares and interests in shares, and interests in overseas real estate. Losses generated from such disposals will not be allowable. Consideration was given to a broader exemption for all chargeable gains, but the proposed approach is considered to balance the objective for an attractive regime with the need to protect against Exchequer risk.

3.39 The meaning of 'shares' is intended to be broad and includes fixed rate preference shares to the extent that these are chargeable assets, as well as a QAHC's equity-like interest in a company that has no share capital.

3.40 'Interests in shares' is also intended to be broad and should cover the following situations:

- Where a QAHC holds an interest in a tax transparent entity that disposes of shares or overseas real estate, the gain or loss should be attributable to the QAHC and be exempt or non-allowable.
- Where a QAHC disposes of its interest in a tax transparent entity, normal rules will apply so the interest in the transparent entity will not be treated as an asset in its own right.

3.41 Disposals of 'UK property rich assets' will be taxed in the usual way along with the disposal of other chargeable assets, such as intangibles and UK real estate. 'UK property rich assets' include shares that derive at least 75% of their value from UK land[9]. Any capital gains or losses arising to a QAHC from non-qualifying items can be reallocated to another member of the corporate group that is not a QAHC, or to the non-qualifying activities of a QAHC, in the usual way[10]..

3.42 The QAHC exemption for gains accrued on overseas real estate is not proposed to be contingent on any disposal being subject to tax in a foreign jurisdiction and is therefore different to the approach taken for the treatment of overseas property income.

3.43 Given that the proposed QAHC gains exemption is unconditional, the government is exploring the introduction of targeted rules to address specific risks, such as the enveloping of certain non-qualifying chargeable assets in order to make exempt share disposals.

3.44 Special rules apply to tax unrealised gains on assets held in funds and similar vehicles for the purposes of an insurer's long-term insurance business. The

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9 As defined under Schedule 1A TCGA 1992

10 Under TCGA 1992

government will ensure that the policy intent of these rules is not disrupted through the use of QAHCs.

Ring-fencing

3.45 Since it is proposed that QAHCs will have access to certain benefits that are not available to other corporate entities that are subject to corporation tax, the government intends to introduce 'ring-fencing' rules to prevent, for example, losses arising on qualifying activities being set against profits arising from non-qualifying activities or profits arising in non-QAHC companies in the same corporate group.

3.46 The government is proposing to introduce tax rules to deem that a QAHC consists of two separate notional entities, one carrying on the qualifying activities, and the other carrying on the remainder of the QAHC's activities. Assets and transactions will be attributed to either one of the notional entities, or where necessary, apportioned between them. Unmodified corporation tax rules will apply to the notional entity with the non-qualifying activities.

Corporate groups

3.47 The concept of a QAHC consisting of two notional entities will carry over into how corporate groups are dealt with under the AHC regime. Where there is a stack of QAHCs, there will be essentially two notional groups: one group consisting of QAHC non-qualifying activities (the 'non-qualifying group') and a second group consisting of the QAHC qualifying activities (the 'qualifying group').

3.48 Group relief will be available within the QAHC qualifying group and the non-qualifying group but not between these two groups. Similarly, tax neutral transfer of chargeable assets will be available within each of the notional separate groups but not between these groups.

3.49 Where a QAHC invests in separate corporate groups, those groups will not become one corporate group simply because of the QAHC investment. Thus, group relief and the tax neutral transfer of chargeable assets will not be available between essentially independent groups.

Transfer pricing

3.50 The government will continue to consult to explore where uncertainty arises in relation to transfer pricing and HMRC will provide guidance setting out its views on the application of transfer pricing rules and principles to QAHCs.

3.51 The government is considering the need to remove the exemption for small and medium sized enterprises and is reviewing the participation condition in relation to QAHCs to ensure that transfer pricing rules apply in all appropriate cases.

CFC rules

3.52 The government does not consider that there is a case for making changes to the CFC regime. Other countries have implemented similar requirements in accordance with the OECD's BEPS recommendations and the application

of CFC rules to QAHCs within the proposed regime is unlikely to impact on the UK's competitiveness.

Hybrid mismatches

3.53 The government recognises the need for clear rules which set out the interaction between the Hybrid and other Mismatches regime and the new AHC regime. These rules will need to support the delivery of the policy objectives of the QAHC regime while remaining compliant with the OECD's recommendations in relation to the treatment of hybrids.

3.54 The government anticipates that it will be necessary to prevent Chapter 3 of the hybrids rules (the provisions dealing with hybrid financial instruments) from applying to payments under profit participating loan arrangements where deductions are to be permitted for QAHCs. The need for any other changes to the hybrids rules remains under consideration.

Corporate Interest Restriction

3.55 The government does not currently envisage significant changes will need to be made to the Corporate Interest Restriction (CIR) rules. Further thought needs to be given as to how disallowances are allocated between qualifying and non-qualifying activities. Further consideration will be given as to whether the standard definition of a CIR worldwide group works effectively in the context of QAHCs. The intention is that where there is a stack of QAHCs, these could form part of a single CIR worldwide group, but where a QAHC owns separate corporate groups, it is not expected to connect otherwise independent groups such that they become part of the same CIR worldwide group.

Entry and exit from the regime

Entry

3.56 The government will provide for existing companies to choose to become QAHCs. In order to prevent loss of tax, assets to be held within the new QAHC will be treated as sold and repurchased upon entry into the rules, with any charge arising at that point. There will be no deferral of any tax charge, but losses, group relief or existing exemptions such as SSE may apply if the conditions are met. The deemed disposal and repurchase would apply to assets relating to qualifying activities only. There will be no deemed disposal of assets that form part of the QAHC non-qualifying entity (outside the QAHC qualifying ring-fence) since the standard corporation tax rules will continue to apply to them.

Exit

3.57 The government is proposing that assets within the ring-fence will be rebased to market value at the time when the QAHC leaves the regime. Assets outside of the QAHC qualifying ring-fence will not be re-based on exit because there will be no change to the way corporation tax rules apply to these assets when within the regime.

Treatment of losses

3.58 The government is still considering the treatment of losses within a QAHC but one possibility is that losses accrued on the qualifying activities prior to the company becoming a QAHC will be unavailable against profits arising within the QAHC qualifying ring-fence. Unused losses generated from qualifying activities while in the AHC regime will be extinguished upon exit.

3.59 The current loss rules will apply in the normal way to the non-qualifying activities outside of the QAHC qualifying ring-fence.

Accounting periods at entry and exit

3.60 It is envisaged that a company will be a QAHC, or not, for the whole of an accounting period. A new accounting period will automatically commence when a company becomes a QAHC, in which the QAHC can access regime benefits in respect of its qualifying activities. Similarly, a new accounting period will start when a company ceases to be a QAHC, after which time the company can no longer access regime benefits.

Temporary breaches of eligibility criteria

3.61 The government recognises that a QAHC could temporarily breach the eligibility criteria and therefore plans to create a set of temporary breach rules that are similar to those already implemented within the REIT regime. These rules classify breaches as 'minor' or 'serious'. Serious breaches may result in automatic removal from the regime whereas minor breaches would not, unless there are repeated minor breaches. What should count as a serious or minor breach is still to be established, but the approach should be familiar to industry, easy to follow and provide certainty.

Gains in the hands of investors

3.62 One of the aims of the new regime is that gains realised by the QAHC and passed up to UK individual investors will be treated as capital in the hands of those investors. To achieve this, the government is proposing to switch off certain distribution rules which would otherwise treat premiums on the buy-back of shares in a QAHC as a distribution and taxable as income in the hands of individual investors.

3.63 Further thought is being given as to how to prevent the regime from being used to defer taxation of income or convert it into capital receipts in the hands of taxable investors without creating unnecessary burdens.

3.64 Investors holding debt instruments that might be redeemed at a premium will be taxed according to the usual rules. The Deeply Discounted Securities and Excluded Indexed Securities rules will apply and will in some cases provide for premiums to be taxed as capital, while giving protection against income to capital conversion. These rules are expected to provide certainty and are familiar to the industry, as they also apply to debt instruments issued by overseas AHCs.

Stamp taxes on shares

3.65 Respondents suggested that an exemption from Stamp Duty and SDRT for any transfer of share or loan capital issued by a new AHC would not represent a loss of tax revenue. However, the government has identified that there would be significant loss of tax revenue in respect of existing AHCs eligible for the regime if these exemptions were provided. This cost would arise most clearly in relation to private equity backed businesses, where the government would expect that, as a commercial matter, the entities in the ownership structures most likely to be sold would generally qualify for QAHC status. The government has therefore decided that it will not be providing an exemption for the transfer of securities issued by a QAHC.

3.66 The government proposes, however, to provide for an exemption for the repurchase by a QAHC of share and loan capital which it previously issued, subject to an anti-avoidance rule to prevent the exemption applying to transactions which are economically equivalent to transfers of securities, effected by way of a subscription for new securities and an associated repurchase.

3.67 The government does not think it necessary to exempt the acquisitions of securities by a QAHC since the location of the AHC does not drive the stamp taxes treatment on the acquisition of assets.

Personal tax and UK situs

3.68 The government has received representations which suggest that in order to ensure the competitiveness of UK AHCs, the remittance basis of taxation should apply to income and gains arising from a foreign asset, even when that asset is held by the UK AHC. Several of the responses also suggested that foreign assets held in a UK AHC should not be treated as UK situs assets for inheritance tax purposes. The government will consider whether a change to the rules is appropriate and necessary in order to ensure the success of UK AHCs.

Employment Related Securities

3.69 The government recognises that there may be some circumstances where it is not clear how the employment related securities rules will apply to directors of QAHCs. The government is considering how best to address potential uncertainty.

Reporting and monitoring

3.70 The government will require that a company that meets the eligibility criteria makes an active choice to join the regime which is notified to HMRC. The method of notification is still to be determined. QAHCs will be required to provide a small amount of information within the corporation tax computation, which will carry XBRL tagging. This information should not be administratively burdensome to collate and is required for policy design and compliance purposes.

3.71 Due to the different treatment that income and gains receive when returned to investors by a QAHC, HMRC may wish to monitor these amounts through reporting requirements imposed on individuals, and therefore changes to

some self-assessment tax forms are being considered. If changes are made to the forms, guidance will be published to explain the new reporting requirements.

3.72 It is intended that the SH03 form will be updated to allow QAHCs to self-certify that stamp duty is not payable on the repurchase of shares.

Senior Accounting Officer regime

3.73 All QAHCs should establish and maintain appropriate tax accounting arrangements to allow tax liabilities to be calculated accurately in all material respects. The government considers that the senior accounting officer (SAO) provisions should apply where a company that is a qualifying company for the purposes of the SAO legislation is a QAHC.

Targeted Anti-Avoidance Rules

3.74 The government considers that it may be necessary to include proportionate targeted anti-avoidance rules to protect the regime from abuse, and to ensure that it operates as intended. The government will continue to consider the best approach to such rules, including, in particular, whether rules should cover the regime as a whole or be limited to certain transactions, such as specific disposals.

Real Estate Investment Trusts

Introduction

3.75 Most responses to the first consultation relating specifically to investment in UK real estate focussed on the REIT regime. Respondents noted a number of areas where the REIT regime could be reformed, to remove unnecessary barriers and make it more competitive, including using REITs as an asset holding vehicle. Responses also noted that provision may need to be made to accommodate REITs holding interests in AHCs and vice versa, and officials will continue to work with stakeholders on that issue.

3.76 As noted in the second stage consultation paper, while a comprehensive review of the REIT rules is intended to form part of the government's wider funds review, stakeholders suggested that there are a number of changes that could be made alongside the introduction of the AHC rules that would have immediate benefits in making the UK a more competitive location for holding real estate assets. That paper set out the areas where changes could potentially be made to the REITs rules to the same timetable as the delivery of a new regime for AHCs and raised further questions for stakeholders to consider. The government's response is detailed below.

The listing requirement

3.77 This is the condition that 'the shares forming the company's ordinary share capital are admitted to trading on a recognised stock exchange.' This is subject to a relaxation for the first 3 years.

3.78 The second stage consultation recognised that this requirement can create unnecessary and costly administrative burdens in some circumstances, such as where a REIT is wholly owned by institutional investors. While most

respondents endorsed that view, some went further and suggested there was no longer any need for such a requirement. Others disagreed, noting that it provides substantial benefits to (non-institutional) investors and helps to promote the concept of a REIT 'brand'. It also supports the government's original policy aim of ensuring suitability for wider retail investor access through the scrutiny required for public companies, increasing access to property investment for the general public.

3.79 The government has concluded that this listing requirement should be removed where there is no obvious benefit. Taking account of the spectrum of views, the government is proposing to remove the requirement for REITs that are wholly or almost wholly (that is, at least 99%) owned by institutional investors[11]. A collective investment scheme operated as a limited partnership (CIS LP) will be subject to a general diversity of ownership (GDO) requirement for this purpose. The listing requirement would still apply to all other REITs. The government acknowledges that some respondents viewed a lower ownership percentage as appropriate and welcomes further comment on any other circumstances where listing brings no obvious benefit to REITs or their investors.

3.80 To avoid creating a cliff-edge where REIT status could be terminated immediately following a change of ownership (for example, if a pension fund sold some or all of its holding in a REIT exempted from the listing requirement to a non-institutional investor), a period of one year for the REIT's shares to be admitted to trading after such a change of ownership is proposed.

Institutional investors and the close company requirement

3.81 The REIT regime prevents close companies from being REITs, unless they are close only because they have a participator who is an institutional investor.

3.82 The second stage consultation document noted that stakeholders had made a number of suggestions in response to the initial consultation on this point, and raised further questions regarding possible additions to the institutional investor list, introducing a close company 'look through' approach similar to that used in the non-resident capital gains rules[12], and changes to the way the rule about overseas equivalent of a UK REIT operates in practice.

3.83 The further responses on these points demonstrate that making changes to the list of institutional investors and to the requirement to be not close has widespread support, but that such changes would also have consequences beyond the immediate REIT rules. In particular, they would affect certain provisions within the non-resident capital gains rules[13] and the substantial shareholdings exemption (SSE) rules[14] .

3.84 The government therefore considers it would be more appropriate to consider such changes as part of the wider funds review, with the exception

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11 As defined in section 528(4A) CTA 2010

12 Sch 5AAA TCGA 1992

13 Sch 5AAA TCGA 1992

14 Schedule 7AC TCGA 1992

of making a change to the 'overseas equivalent' rule to the AHC timetable. That rule is relatively self-contained and is recognised as being particularly problematic in some circumstances.

3.85 It is proposed that the 'overseas equivalent' rule will be modified by removing the reference to 'the law of the territory'[15] and providing updated guidance in the Investment Funds Manual. The guidance would reference the OECD Commentary on Article 10 of the model treaty which states that a REIT may be loosely described as a widely held company, trust or contractual or fiduciary arrangement that derives its income primarily from long-term investment in immovable property, distributes most of that income annually and does not pay income tax on the income related to immovable property that is so distributed.

3.86 The government will continue to engage with stakeholders to consider further changes to the institutional investor list and to the non-close requirement, including a requirement for certain institutional investors to be widely held by either meeting a genuine diversity of ownership condition or being non-close, dependent on the vehicle type.

Holders of excessive rights rule

3.87 The holder of excessive rights (HoER) rule prevents loss of tax to the UK Exchequer that might otherwise arise as a result of the operation of the UK's double taxation agreements (DTAs). A holder of excessive rights is defined as being a person who is beneficially entitled to at least 10% of the distributions, at least 10% of the share capital or controls at least 10% of the voting rights.

3.88 As noted in the second stage consultation, this can lead to certain investors in REITs needing to fragment their shareholdings, creating complicated and costly structures solely to remain under the 10% limit, even where those investors are entitled to receive gross property investment distributions (PIDs).

3.89 The original purpose for including gross PID recipients within the scope of the HoER rule was to support the government aim that REITs should have a broad investor base. The evolution of the REIT rules, in particular the introduction of relaxations to the non-close test with regard to institutional investors, mean that rationale does not always apply. Taken together with the broad consensus of respondents that the rule should be updated to reflect this, while also recognising the government's ongoing need to prevent loss of tax, it is proposed that changes are made to the HoER rules to exclude those investors to whom PIDs can be paid gross when considering whether a HoER charge should be applied.

3.90 The government is not currently minded to exclude investors to whom PIDs are paid after deduction of withholding tax but who may subsequently be entitled to a repayment of that tax because of their status (for example, some foreign pension funds or sovereign immune entities), because this can

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[15] In section 528(4A)(j) CTA 2010

be an area of uncertainty and the current formal reclaim process provides some oversight.

3.91 Government officials will continue to engage with stakeholders to consider changes to the list of entities entitled to gross payment of PID.

The balance of business test

3.92 The balance of business test ensures the focus of a REIT is on holding and managing property, while recognising that it might undertake some ancillary activities.

3.93 The second stage consultation set out a number of suggestions as to how the rule could be reformed. Given the general consensus of views received, and the low level of risk to the Exchequer, the government is proposing to introduce two changes to the rule now and to consider whether any further changes are necessary as part of the wider funds review.

3.94 The first proposed change is to extend the list of exclusions from profits taken into account for the test, adding to that list residual business profits resulting from compliance with planning obligations entered into in accordance with section 106 of the Town and Country Planning Act 1990. This would mean that such profits would normally be left out of account when applying the balance of business test.

3.95 The second proposed change is to introduce a gateway test based on consolidated accounts, so that a REIT would only have to prepare all the required financial statements for each group member if it failed the gateway test. This gateway test would allow completion of a single statement of the group's property rental business profits and a single statement of the group's residual profits. If these statements show group property rental business profits or assets to be 80% or more of total group profits or assets, the full financial statements for each group member will not be required. The proposal is that this is a two-part test, with one part for profits and one for assets. If only one part is failed, then the full test is only required for that part.

Chapter 4

Next Steps

4.1 As mentioned in Chapter 1, the government has, alongside this summary of responses, published a set of draft clauses. These cover some of the core elements of the proposed AHCs regime and are available to view here.

4.2 The government is keen to engage again with stakeholders to resolve open aspects of the policy design and to ensure that the legislation as drafted will successfully deliver the policy intent set out in Chapter 3. A small but diverse working group will be established for this purpose.

4.3 Expressions of interest to join the working group are welcome from tax professionals who are likely to be involved in the creation or operation of QAHCs. Please contact the policy team by email at ukfundsreview@hmtreasury.gov.uk, setting out which investment management strategies you have involvement in, as well as any other experience that you consider is relevant to the working group.

Annex A
List of Respondents

- Alternative Investment Management Association
- Alternative Credit Council
- Akin Gump LLP
- Aviva Investors
- BDO LLP
- Bould Consulting Ltd
- Brookfield Asset Management
- British Venture Capital and Private Equity Association
- Deloitte LLP
- DLA Piper LLP
- European Public Real Estate Association
- EY LLP
- FTI Consulting LLP
- Global Infrastructure Investor Association
- Grant Thornton UK LLP
- Great Portland Estates plc
- Herbert Smith Freehills LLP
- INREV
- Investment Property Forum
- IP Group plc
- IPSX
- KPMG LLP
- Legal & General group plc
- Linklaters LLP
- Macfarlanes LLP

- Melville Rodrigues Consulting LLP
- Osborne Clarke LLP
- PwC LLP
- Richard Stratton (Mr)
- Sanne
- Segro
- Simmons & Simmons LLP
- The Association of Investment Companies
- The CityUK
- The Commercial Real Estate Finance Council
- The Law Society
- The Association of Real Estate Funds
- Wayhome

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