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The Tax Treatment of Asset Holding Companies in Alternative Fund Structures
Response to second stage consultation by Simmons & Simmons LLP

1. Introduction

1.1 Simmons & Simmons LLP welcomes the opportunity to submit formally its responses on the second stage consultation entitled "The Tax Treatment of Asset Holding Companies in Alternative Fund Structures" (the "**Consultation**"). We are supportive of the principles and purpose of the Consultation.

1.2 Simmons & Simmons LLP is a leading international law firm with offices in major business and financial centres throughout Europe, the Middle East and Asia.

1.3 Given the breadth of the matters covered in the Consultation, we have sought to focus on the high level principles behind the proposals and to outline our preferred approach to any future UK AHC regime, rather than responding to each of the specific questions raised in the document. We have grouped our comments under the headings set out in the Consultation for ease of review.

2. Overview

2.1 Before getting into the detail of our comments, we consider it helpful to identify certain key principles that should underpin any reform to the taxation of AHCs, as follows:

(A) the AHC regime would be best established as a standalone regime, rather than an overlay to existing provisions in the UK tax code;

(B) the eligibility conditions for the AHC regime should be simple to understand and clear to apply in practice;

(C) the regime should be competitive against regimes in jurisdictions such as Luxembourg and Ireland;

(D) the regime should adequately cater for the requirements of UK non-domiciled investors by treating income and gains as non-UK source, as otherwise such investors will continue to prefer investment via non-UK AHCs;

(E) any provisions dealing with the UK tax position of UK investors in AHCs should sit outside the "core" AHC regime, so that promoters of funds without relevant investors that would wish to use a UK AHC do not need to comply with those aspects of the regime;

(F) where possible, it would be preferable to adopt/adapt existing provisions of the UK tax code that apply to UK investors in non-UK AHCs so that these apply to UK AHCs, rather than creating a new separate regime for those UK investors;

(G) any regime should be simple to administer in practice, in addition to being readily understandable for fund promoters and investors; and

(H) given the principles of Parliamentary sovereignty, consideration should be given to how change of law risks could be addressed, for example whether it might be possible to provide a contractual undertaking to each eligible AHC by way of deed,

to the effect that no change of law or tax authority practice may be implemented that would be adverse to the interest of relevant AHCs[1].

2.2 Although outside the scope of the Consultation, the VAT treatment of investment management and other services provided to AHCs will also be very relevant to the likely take up of UK AHCs, and will require careful consideration in the context of the broader funds review. Imposing a UK VAT charge at UK AHC level, or creating an input VAT recovery restriction for managers and other service providers providing services to UK AHCs by treating those services as VAT exempt rather than zero-rated, will significantly impede the adoption of UK AHCs.

3. Eligibility

3.1 Given the breadth of structures that may wish to make use of the AHC, we advocate for as broad a set of eligibility criteria as possible, whilst accepting that some criteria are justified to protect against exchequer risks.

3.2 We would propose that where an AHC is wholly or mainly (i.e. more than 50%) owned by investment funds or other entities that are subject to discretionary investment management or which receive investment advice from an independent fund manager or fund adviser, this should qualify for the AHC regime.

3.3 We do not favour the introduction of a widely held or genuine diversity of ownership requirement, on the basis that this could introduce material uncertainty as to the application of the AHC regime in particular circumstances.

3.4 When assessing the independence of the fund manager or adviser, the eligibility conditions should permit some level of co-investment and/or carried interest being held by the fund manager or adviser.

3.5 Given the current focus on co-investment, the regime should also facilitate situations where an AHC is "self-managed" by its board of directors or equivalent, but is effectively used as a pooling vehicle through which one or more funds and direct co-investors (together with carry holders, potentially) can invest in an underlying investment opportunity.

3.6 To the extent HMRC is concerned about exchequer risk, we consider that this should not be addressed by imposing a maximum level of investment by UK taxable investors, as this will create risks for other investors in that AHC where the relevant threshold is breached. Instead, we consider that the better approach to revenue protection would be to apply existing anti-avoidance rules that apply to non-UK AHCs (such as the transfer of assets abroad rules, the attribution of gains of close companies (section 3 TCGA) rules and the controlled foreign companies rules) to UK AHCs.

3.7 From discussions with HMRC, we understand the preference is for AHCs to be largely passive investing vehicles. However, we consider that any regime should permit a degree of ancillary trading activity in respect of the underlying investments, to maintain competitiveness with AHC regimes in other jurisdictions and to avoid a consideration of the "badges of trade" and potential tax leakage in the context of UK AHCs.

[1] This could be similar to the "decommissioning relief deed" mechanism adopted in the oil and gas sector, under which relevant companies benefit from a contractual indemnity from the government should the amount of tax relief for decommissioning assets ultimately received be less than a specified reference amount. In the context of an AHC, such an indemnity could cover any additional UK tax liabilities that arise as a result of a relevant change of law or tax authority practice after the indemnity deed has been entered into.

3.8 To allow for future flexibility, the AHC primary legislation should include broad powers to add, amend or restate aspects of the regime by way of secondary legislation, including as to the eligibility conditions.

4. Profit on income received by the AHC

4.1 We favour an approach where the AHC is taxed on its true "economic" retained income profit. On certain particular aspects:

(A) we support the proposal to introduce rules permitting a tax deduction for results-dependent interest paid by the AHC – generally we would recommend that all payments made by an AHC should be treated by default as tax deductible;

(B) elements of the UK tax regime of general application to corporates, such as the hybrid mismatch rules, loss restriction rules and corporate interest restriction rules, should be disapplied; and

(C) areas which can cause material uncertainty in practice, such as transfer pricing rules, should be disapplied, or their application should be modified for example to require only a de minimis taxable profit to be retained by way of safe harbour, to take account of the nature of the AHC's activities and the minimal functions and risks that it bears.

4.2 Given that UK AHCs may be used for investment into other jurisdictions, where the desire may be to take account of double tax treaty benefits and reliefs, we do not see that the UK regime should mandate a certain level of taxable profit or minimum spread beyond the situation referenced in paragraph 4.1(C) above concerning a potential transfer pricing safe harbour. Rather, any such level of profits should be determined by the approach in the underlying investee jurisdiction, including to take account of any substance requirements that the AHC must meet in that jurisdiction.

5. Capital gains realised by an AHC

5.1 We support a broad exemption from tax for capital gains realised by UK AHCs, rather than extending or modifying the application of the current substantial shareholding exemption to such vehicles.

5.2 The latter exemption can prove complex to operate in practice relative to regimes that AHCs in other jurisdictions may benefit from, such as the Luxembourg participation exemption. In other such jurisdictions, the application of the exemption from tax on gains is generally an objective matter that can be confirmed at the outset and which should not generally be expected to change over the life of the AHC.

5.3 We do not see that the UK AHC regime should mandate the distribution and/or reinvestment of gains, but this should instead be determined by commercial factors.

5.4 Whilst a regime allowing gains to be "streamed" to UK taxable investors would, on the face of it, be attractive, we do not consider that this should be a mandatory requirement of the regime. Instead, funds or AHCs which have sufficient UK taxable investors to merit the additional administrative costs of "tracing" gains through a structure should be able to opt into a regime permitting streaming. Where the AHC does not opt into such a regime, the normal rules should apply, including applicable anti-avoidance rules as referenced at paragraph 3.5 above.

6. Withholding tax on payments of interest to investors

6.1 A UK AHC should benefit from a broad exemption from UK withholding taxes on all payments made to investors, covering not just interest but also annual payments.

6.2 Whilst an AHC could in principle benefit from other existing exemption regimes, e.g. the quoted Eurobond exemption or the qualifying private placement exemption from withholding tax on UK source yearly interest, there is a cost and/or a compliance burden associated with those regimes that would place the UK regime at a disadvantage to competitor regimes in other jurisdictions.

6.3 A standalone regime for AHCs (policed via the eligibility criteria outlined above) would address these concerns.

7. Income and gains paid to investors

7.1 We would generally recommend that investors should be taxed in line with the normal UK tax rules based on the nature of the returns they receive from an AHC, supplemented where appropriate by other rules, for example:

(A) to apply appropriate UK anti-avoidance rules, such as those outlined at paragraph 3.5 above, where reasonable and proportionate to do so, having regard to the purpose of the AHC regime and the nature of any exchequer risks that may arise;

(B) to permit the "streaming" of gains to UK investors, but on an optional basis, as outlined at paragraph 5.4 above; and

(C) to maintain competitiveness against non-UK AHC regimes, to provide that income and/or gains derived from a UK AHC should be regarded as non-UK situs for income, capital gains and inheritance tax purposes.

7.2 We understand that HMRC has a concern that AHCs could be used within corporate groups in order to realise a gain at AHC level that would benefit from the AHC gains exemption in circumstances where the "normal" substantial shareholding exemption would not be available, with the gain being returned to the UK corporate investor via dividend benefiting from the dividend exemption from corporation tax. Given the proposed eligibility criteria outlined at paragraph 3 above, we question whether it would be possible to structure a UK AHC with the sole purpose of achieving this objective.

7.3 However, should this be a legitimate concern, we consider one approach could be to provide a targeted anti-avoidance rule enabling the dividend exemption to be disapplied in respect of dividends paid by AHCs where the overall AHC had a main purpose of facilitating the receipt of an exempt dividend derived from a tax exempt gain realised at AHC level which would have been chargeable had it been realised at the level of the UK corporate investor.

8. Real estate

8.1 We accept that real estate is a particular asset class that can present challenges in a fund context.

8.2 We accept that where UK real estate is involved, the UK will want to retain UK taxing rights in respect of income and/or gains realised directly or indirectly from that UK real estate. Care will need to be taken to ensure that appropriate amendments are made to the UK non-resident capital gains regime to facilitate the use of AHCs within the scope of those rules.

8.3 For non-UK real estate, we recommend the starting position should be that income and/or gains realised directly or indirectly from non-UK real estate should be exempt from tax at the level of the AHC, rather than being taxable but with credit for local taxes paid in the jurisdiction where the real estate is located.

8.4 Given that taxing rights in respect of income and gains from real estate are allocated under most double tax treaties to the latter jurisdiction, we see less of an argument to impose a

UK tax charge at AHC level on relevant income and gains to maintain double tax treaty access.

9. Stamp duty and SDRT

9.1 We strongly support the introduction of a stamp duty / stamp duty reserve tax exemption on share repurchases or buybacks by a UK AHC where this is the mechanism adopted to return proceeds to the fund(s) that own the AHC. Imposing a stamp tax charge in such circumstances would be a significant impediment to adoption of a UK AHC regime.

9.2 More generally, we recommend that serious consideration be given to securing that transactions in equity and debt interests, including results-dependent and other equity-like debt, in a UK AHC should be exempt from UK stamp duty and stamp duty reserve tax, both on issue (which is the case under current law) and any subsequent transfers (which would not apply where the AHC is a UK incorporated company).

9.3 Although on the face of it, this could present opportunities for UK equities to be "enveloped" in an AHC and then traded, we would see that the deemed market value provisions imposing a market value stamp duty / SDRT charge on the transfer of relevant equities etc. to connected companies could be used to police any such arrangements.

9.4 We would also note that if a broad exemption from stamp duty and SDRT is not adopted, it would be open to taxpayers to establish a Jersey incorporated, UK tax resident company with a share register maintained outside the UK, that would permit access to the UK AHC direct tax regime whilst permitting shares and other interests in that Jersey company to be traded without UK stamp taxes. There should therefore be no exchequer risk in adopting such a broad exemption from UK stamp taxes.

10. Corporate groups

10.1 As a general proposition, we agree that an AHC should not be treated as a member of a group for general corporate tax purposes.

10.2 It is common, however, for structures commonly adopted by funds to involve the use of multiple AHCs, for example to enable structural subordination of shareholder debt and equity claims behind the claims of senior lenders to the structure.

10.3 The AHC regime should be flexible enough to facilitate AHCs in such a structure to be treated as grouped for relevant purposes, e.g. to enable the movement of assets or cash between those AHCs without any frictional tax costs.

11. Entry and exit from the regime

11.1 We accept that some provisions may be required to prevent entities switching in and out of the AHC regime where this is tax motivated.

11.2 It should be possible for existing entities that meet the AHC eligibility criteria to elect for the new regime to apply to them, although this should be on an elective rather than a mandatory basis and a sufficient time period should be allowed to enable a decision to be made as to whether electing into the regime would be beneficial.

11.3 However, we would caution that adopting a set of entry and exit rules which is overly broad and which could result in the clawback of the benefits of the AHC tax regime may be counterproductive. The investor base in funds that may make use of AHCs is not static, and so imposing a clawback on the current population of investors may not be appropriate.

12. Other tax issues and anti-avoidance

12.1 See our comments elsewhere in this response regarding our preferred approach of applying existing specific UK anti-avoidance rules to UK AHCs, in the same manner as they apply currently to non-UK AHCs. As stated, any such application must be reasonable and proportionate, having regard to the purpose of the regime and its intention of fostering the use of AHCs by funds and other investors.

12.2 In addition to these rules, we note that the general anti-abuse rule would also be available to challenge any contrived structures that seek to exploit the benefits of the UK AHC regime in a manner which poses exchequer risk. This could be supported by having a clear statement in the AHC regime setting out the purpose and intention of the regime.

12.3 Although we discuss at paragraph 7.3 a potential TAAR that could be considered where the AHC gains exemption was being exploited inappropriately, generally we do not favour the use of TAARs under the "core" AHC regime, as these will introduce uncertainty as to the potential application of the regime and may necessitate a robust pre-clearance process which would require additional HMRC resources.

13. Reporting and monitoring

13.1 We would caution against imposing significant additional reporting and/or monitoring obligations on UK AHCs. We do generally not see such measures being adopted by other jurisdictions.

14. REITs

14.1 Overview

(A) Of the various measures discussed in the Consultation, we consider the proposed REIT changes to have the potential to be the "quickest wins" in terms of their immediate benefit on existing and potential users of UK REITs. We therefore generally support what is proposed, subject to a number of comments as set out below. We note that the funds review call for input contains other provisions aimed at longer term reform to the REIT regime, which we also support.

(B) In addition to the proposals below and in the call for input, we would welcome consideration being given to the possible introduction of mortgage REITs in the UK, to enable a closed ended vehicle to be created to facilitate the tax efficient holding and investment in real estate debt similar to the US mortgage REIT regime. This has been raised previously yet never gained traction; however, we consider that it should be actively reviewed as part of the wider funds review proposals.

14.2 Listing requirement

(A) Whilst we note that HMRC is not currently minded to remove the listing requirement entirely, we support the proposal that the requirement could be relaxed or removed where the REIT is sufficiently owned by institutional investors.

(B) We consider that requiring the REIT to be wholly owned by institutional investors is overly restrictive, and would favour some permitted level of investment by non-institutional investors, for example by the external manager of the REIT or the principals behind that manager. It is commonly the case that investors may require an investment manager to have "skin in the game" and any relaxation of the listing requirement should anticipate this up to a suitable threshold of, say, 10%.

(C) In addition, to avoid issues when investors at REIT level change, a suitable buffer should be allowed such that if an institutional investor wishes to sell all or part of their investment to a non-institutional investor, this is permitted and REIT status continues unbroken provided that the relevant interested in the REIT are listed or admitted to trading on a relevant exchange by, say, the end of the accounting period in which the sale takes place. This would avoid listing becoming a condition precedent to any sale, which could have an adverse impact on REIT liquidity.

14.3 **Institutional investors and the close company requirement**

(A) We agree that the list of institutional investors should be reviewed on a regular basis to ensure it remains appropriate in light of market developments.

(B) On a number of aspects of this list:

(1) we would recommend care be taken regarding any adoption of new widely held or genuine diversity of ownership requirements for existing classes of institutional investors on the HMRC list – to the extent that any changes are proposed, existing investment arrangements for REITs should be grandfathered indefinitely;

(2) on the foreign REIT equivalent limb, we consider that the focus on the foreign REIT regime, as opposed to the circumstances of the specific foreign REIT itself, has led to this limb being interpreted in an overly restrictive manner, for example in the context of South African REITs given the nature of the local regime to which they are subject and the manner in which the South African rules do not directly mandate a broad ownership requirement. In a situation where a South African REIT is in fact broadly held, it should meet the foreign REIT equivalent limb; and

(3) as to the level of comfort that HMRC needs to satisfy itself that the necessary requirements are met, we see this as a matter which is best policed by the REIT itself, should it become a close company, with the ability to remedy any breach of the close company requirement by the end of the accounting period after the period in which the breach occurred provided that the breach arises not as a result of anything done by the REIT.

(C) As part of reviewing the close company requirement it may be appropriate to consider a further relaxation where the REIT takes reasonable steps to meet the close company requirement but these fail for reasons outside the REIT's control, for example where market conditions prevent the placing of sufficient shares with other investors to meet the requirement. This is an approach already taken elsewhere in the UK tax code, e.g. the investment manager exemption 20% test.

14.4 **Holders of excessive rights rules**

(A) Although fragmentation is well accepted, and now helpfully discussed in the HMRC guidance in the Investment Funds Manual, we regularly see questioned whether fragmentation arrangements could be viewed as inappropriate.

(B) We therefore support the removal of fragmentation requirements where the underlying PIDs can be paid to the relevant investor gross, such that there is no risk of loss of tax as a result of a shareholding in the REIT being aggregated.

(C) The position of certain investors, such as foreign pension funds and sovereign wealth funds, under the holders of excessive rights rules can be unclear, e.g. does a sovereign wealth fund qualify as a company or other body corporate subject to

those rules. We are aware that the position has been dealt with via rulings in the past. Although not strictly covered in the Consultation, we would favour additional legislative clarity on the position, for example by providing that an investor who is exempt from UK tax on all income and gains by virtue of sovereign immunity cannot be a holder of excessive rights.

14.5 **The balance of business test**

(A) We support each of the measures discussed at paragraph 5.9 in the relevant section of the Consultation on reforms to the balance of business test.

(B) Given changes to the manner in which commercial property is being used and let in the UK, in particular the move away from the traditional long term letting of office property to a more flexible model for corporate occupiers, we consider that additional clarity should be provided, ideally by way of legislation, to the effect that the leasing or making available of property, including serviced offices, using a more flexible model is still treated as within the property rental business, rather than counting towards the balance of business on an income or assets basis. Whilst the guidance on the investment : trading borderline in the Investment Funds Manual is helpful, it does not always provide sufficient certainty, particularly where ancillary services are being provided as part of a package to the occupier.

(C) Similarly, in the residential context, the adoption of shared ownership or similar models for occupation should be addressed, and it should be made clear that such activities are within the property rental business, rather than counting towards the balance of business.

15. **Contact details and next steps**

To discuss any of the points raised in this response further, please contact Martin Shah, Partner, Simmons & Simmons LLP, at martin.shah@simmons-simmons.com or on 020 7825 4638.

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