Sent via email to: Samuel.Deaner@hmtreasury.gov.uk

19 August 2020

Response to HM Treasury consultation on the use of Asset Holding Companies in alternative fund structures

The Alternative Credit Council (ACC)[1], the Alternative Investment Management Association (AIMA)[2] and the Managed Funds Association (MFA)[3] welcome the initiative of HM Treasury (HMT) to consult on the role of Asset Holding Companies (AHC)[4] as part of the broader review of the UK funds regime. All our comments are made with respect to the use of AHCs by credit funds.

Private credit represents one of the fastest growing asset classes within the alternative investment sector, growing from an estimated $238bn AUM to $768bn AUM between 2008 and 2018.[5] Our own research indicates that nearly 70% of private credit fund managers expect to increase the amount of credit they provide to SMEs over coming years.[6] While a significant number of private credit managers carry out their portfolio management function in the UK, and a substantial

1 The ACC currently represents over 170 members that manage over $400bn of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy, providing finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business. The ACC's core objectives are to provide direction on policy and regulatory matters, support wider advocacy and educational efforts, and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

2 AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org

3 MFA represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and many other regions where MFA members are market participants.

4 https://www.gov.uk/government/consultations/tax-treatment-of-asset-holding-companies-in-alternative-fund-structures

5 *See* page 14 Financing the Economy 2019 – the future of private credit www.aima.org/uploads/assets/083f8b56-2636-4b88-a300a2c612f775ae/20112019-FINAL-FTE-Paper-Single-Page-High-Res.pdf

6 *See* page 21. Ibid.

amount of European private credit lending involves UK businesses,[7] many choose to use non-UK funds or AHCs to facilitate their investments, primarily to provide tax neutrality for their global investor base with respect to their investments.

'Private credit' is a broad term that captures both liquid and illiquid credit strategies, and both performing and distressed debt. In practice, most strategies will typically target a mixture of both illiquid and liquid assets although the relative balance will vary depending on their investment mandate and market opportunities. The liquid / illiquid nature of the assets and the type of return expected (primarily interest income generated by the asset or potential gains on the asset itself) will influence how credit funds use an AHC to execute their strategy and how the AHC might function in practice.

We believe that the introduction of an AHC regime for private credit managers would be attractive to many private credit managers and the ACC and AIMA supports HMT's consideration of this matter. We encourage HMT to build an AHC regime based on the following key principles: (1) provide a framework that is designed to preserve tax neutrality for underlying investors in private investment funds; (2) make the UK regime competitive with existing regimes; (3) ensure the regime is and will remain compatible with developing standards from the Organisation for Economic Co-Operation and Development (OECD); and (4) treat the AHC regime as a building block to developing a comprehensive "on-shore" regime for investment funds more generally that provides a flexible framework for the variety of private fund investment strategies that minimizes complexity and promotes tax neutrality for underlying investors.

We have provided detailed comments on the questions posed by HMT in this consultation but would highlight the following points from our response:

- Any UK AHC regime would, at a minimum, need to be on a par with those currently available to credit fund managers in other EU jurisdictions.
- Credit funds include those targeting liquid and illiquid strategies as well as both par and distressed lending opportunities. It will be essential that any UK AHC has the flexibility to be used by credit funds across this spectrum rather than just a narrow subset.
- If the UK were to introduce an AHC for credit funds, we believe that this could provide both direct and indirect economic benefits to the UK through the creation of additional UK activity. Introducing an AHC will also provide a strong signal to the market that the UK intends to maintain its competitiveness as an international asset management centre.
- Introducing a bespoke regime for AHCs would be more appropriate than amending the securitisation rules. We do not believe it would be possible to provide the flexibility required by credit funds without unduly distorting the original intent of the securitisation rules.
- A new AHC regime is likely to require the following features to be attractive to credit fund managers:
    - <u>Subject to tax on a margin</u>: We anticipate that the AHC would be subject to corporation tax. The amount taxable would effectively be the margin from loan

[7] See Deloitte Alternative Deal Tracker - https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/corporate-finance/deloitte-uk-aldt-spring-2020.pdf?nc=1

relationships and derivative contracts. Determining the margin would be on established transfer pricing methodologies that would be set out in legislation.

- Revise UK anti-hybrid rules: It would be necessary to consider the interaction between how any future UK AHC regime would interact with the UK anti-hybrid rules. For a UK AHC to be attractive, it will be necessary for the UK anti-hybrid rules to be aligned with ATAD II such that they are only relevant when then the hybridity is the cause of non-inclusion.
- Removing WHT on interest payment made by the AHC: This could be achieved by following international practice and removing the WHT obligation on payments to non-individuals. This would provide taxpayers with more certainty without creating excessive risk to the Exchequer or being inconsistent with broader UK tax policy.
- Treatment of capital gains: While credit strategies do not typically target capital gains, these can occur depending on the circumstances of the borrower or broader economic environment. In these circumstances, the capital gains treatment should be retained for the proportion of the returns provided to investors rather than have this treated as income.
- Extension of Substantial Shareholding Exemption (SSE): Where the AHC has small equity stakes and warrants, there would need to be a way in which it could qualify for the SSE.
- Amend deemed distribution rules: In line with the securitisation rules, we suggest that the credit AHC rules would switch off the deemed distribution rules. This would allow AHC to be funded by profit participating debt.
- VAT: While any VAT treatment of a UK AHC would need to be reassessed in light of the planned VAT on fund management review, we would expect any UK AHC to be able to join a VAT group in a similar fashion to partnerships.

- It will be important to establish the entry criteria for the regime and for these to be straightforward for taxpayers to understand and apply. To qualify, we suggest that the credit AHC be entirely held by qualifying investors and where relevant qualifying management.
- We would strongly encourage HMT to ensure that any AHC proposals are aligned with any broader changes considered under the review of the UK funds regime to ensure these are aligned.

We would be happy to discuss any of our comments further should that help HMT's consideration of these matters.

Nicholas Smith Director ACC	Paul Hale Managing Director AIMA	Michael Pedroni Executive Vice President and Managing Director, Head of International Affairs MFA

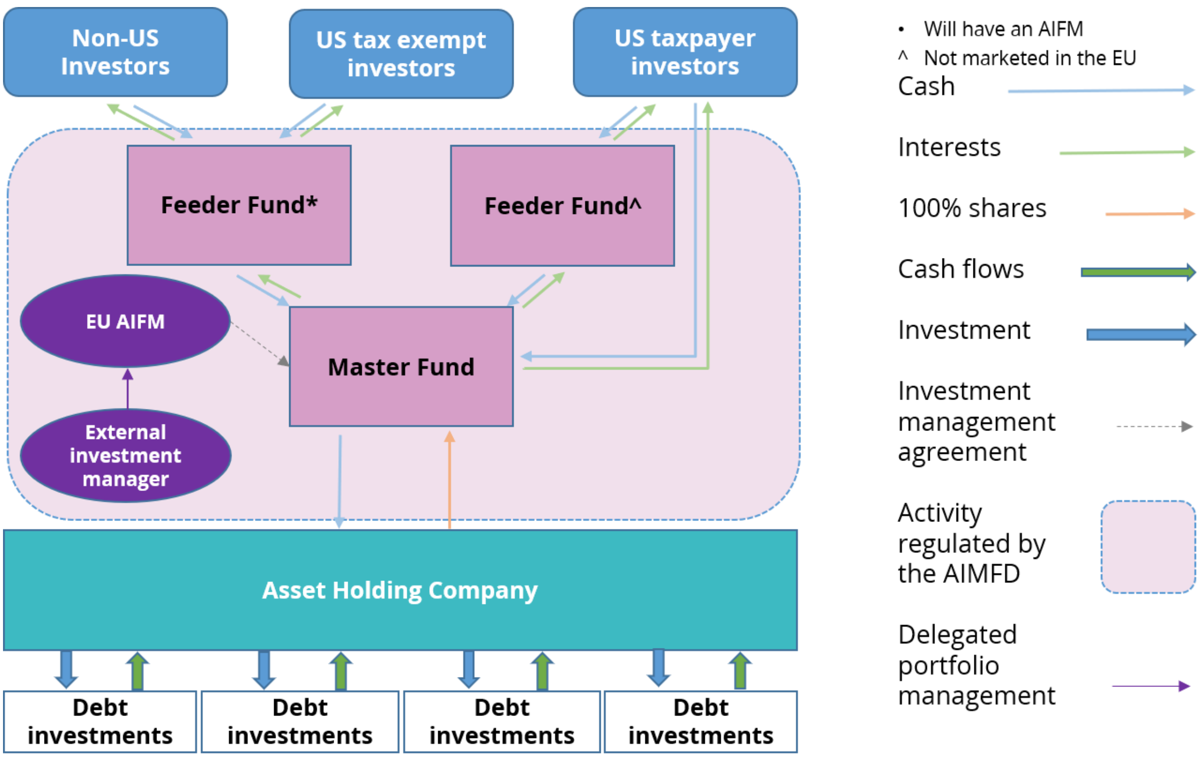
Annex 1

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

It is typical for funds following a credit strategy in Europe to invest via intermediate investment holding vehicles. Luxembourg and Ireland are the most popular EU jurisdictions for the establishment of investment holding vehicles. These may be normal taxable companies (e.g. Luxembourg Soparfi) or securitisation type vehicles (e.g. Luxembourg securitisation vehicles or Irish s.110 companies)[8] subject to special tax regimes.[9]

While the use of AHCs within investment fund structures varies between private credit managers (e.g. depending on the type of strategy being undertaken, nature of the underlying assets, investors in the fund) the following graphic provides an example of how AHCs are typically used by credit fund managers pursuing a European lending strategy.

<u>Typical private credit fund structure (for illustrative purposes)</u>



As a wholly owned subsidiary of the master fund (which may be in a limited partnership (LP) or corporate form), the AHC remains ultimately subject to the oversight of the master fund's fund

[8] An overview of these vehicles and typical structures is provided in the annex to this letter.

[9] We are not suggesting the UK simply mirror any of these frameworks; we provide them for informational purposes to HMT.

manager (AIFM). The investment holding vehicle will also have to conform to the commercial terms of the master fund's investment management agreement. Depending on the nature of the underlying investments, credit funds may use more than one AHC for administrative purposes.

Loans are made to borrowers whose funding requirements are aligned with the investment mandate of the master fund. Any loans or debt investments are subject to rigorous credit and risk analysis. While this due diligence is typically conducted by the AIFM (or a separate investment manager if one has been appointed by the AIFM to perform this activity on its behalf), any investment will need to be approved by the board of the AHC which is independent of the fund and the AIFM. Once the loans have been funded, the borrowers' repayments (interest, principal, and related fees) will flow through the AHC to the master fund. Borrowers predominantly use the credit provided to finance acquisition, expansion, debt refinancing and project finance. Borrowers tend to be mid-cap firms who are unable to access public markets and may have limited access to traditional bank financing, which means that private credit fills an important financing gap in the economy.

AHCs can provide four main benefits for private credit investors compared to direct investment by the alternative investment fund:

- **Legal and regulatory** – AHCs can limit any investment or portfolio liability through a corporate veil rather than the partners in the fund partnership or equivalent investment fund vehicle. AHCs can act as a platform through which the fund contracts with counterparties - i.e. buying and selling assets – in a more efficient way than if the assets were held in the fund directly. In addition, AHCs also make it easier to ring-fence the liabilities of asset portfolios and aggregate multi-partnership funds or co-investments and joint ventures alongside the main fund.

- **Financing** – AHCs can help facilitate financing and funding for the credit investment, by allowing for co-investment or third-party borrowing, at a level that relates more closely to the underlying investments, and in a vehicle those lenders feel more comfortable with than a fund. The AHC also allows for related party financing to the asset portfolio to be made at the AHC level and facilitates the ability to incorporate hedging and foreign exchange mechanisms. The leverage employed by private credit firms varies depending on (i) the appetite of their investors for leverage within the strategy and (ii) the type of lending or credit strategy undertaken.

- **Administrative** – AHCs can help reduce the administrative burdens that would arise from direct fund investment, particularly in relation to the challenges end investors may otherwise face when claiming treaty benefits or domestic exemptions to which they would be entitled if directly invested. This supports the tax neutrality of the credit fund structure and allows the strategy to remain competitive against other investment opportunities. In addition, the AHC can support more efficient centralised management and operational control of fund assets and provide greater flexibility for the growth and development of asset portfolios and cash repatriation to fund investors. AHCs can also make it easier to manage reinvestment opportunities within the investment period of the fund, though this is typically only carried out as part of more liquid credit strategies. Illiquid credit strategies will typically not see capital reinvested as debt investments lasting several years make it hard to reinvest this capital within the investment period of the fund.

- **Tax neutrality** – As noted above tax neutrality is an essential component of a credit strategy. This can be difficult to achieve via partnerships depending on the make-up of the investor base and the assets involved. The additional administrative cost and complexity involved therefore acts as a disincentive for investors seeking to invest in these assets through pooled vehicles. An AHC co-located in the same jurisdiction as the fund or portfolio management activity faces fewer challenges in this regard, particularly in relation to demonstrating principal purpose and substance. The implementation of BEPS Action 6 has also incentivised the use of AHCs more generally across the investment management sector.

The table below provides an illustration of how AHCs are used and may function in practice depending on the nature of the credit strategy.

Typical credit strategies and implications for AHCs

The table below provides an overview of how the use of AHCs may differ depending on whether the credit strategy / assets are mainly liquid, illiquid, a mixture of liquid and illiquid. Private credit fund strategies are primarily focussed on illiquid or less liquid assets. The investment mandate of the private credit fund will also envisage holding these assets to maturity. This 'buy and hold' approach is likely to be at the heart of the investment strategy. While some situations may occur where an early exit or sale of the assets is required (for example, where the investor requests this to meet a liquidity need elsewhere in their portfolio) this would not be the same as trading which is commonplace among more liquid credit strategies that may be pursued by other alternative investment managers.

The way in which credit strategies might use AHCs is largely determined by the nature of the credit strategy and underlying assets. The table below provides an overview of how the use of AHCs may differ depending on the underlying nature of the assets and investment strategy. Please note this is a general overview for illustrative purposes and that

	Mainly liquid credit strategies	Mixed credit strategies	Mainly illiquid credit strategies
Typical assets	Loan participations, CLO notes, trade finance	Asset based lending, receivables, SME lending, opportunistic credit	Direct lending, real estate debt, infrastructure debt
Maturity profile	Typically less than one year	Between zero - four years	Two - six years although sometimes longer
External finance at the AHC level	Yes. Typically a revolving credit facility that would be drawn down as required.	Yes. Likely to be a combination of finance secured against the assets of the holding company via a share pledge and	Yes, although this is less frequently employed by illiquid credit strategies. Where used, it would be secured against

		a credit facility that would be drawn down as required. The use of finance and combination of these approaches will depend on the nature of the underlying assets. In some instances (e.g. CLOs) there may be some use of securitisation.	the assets of the holding company via a share pledge and likely to be term debt.
Hedging / forex	Yes. This will likely be carried out in consideration of the broader portfolio as well as the underlying assets and take place more frequently. This is likely to be bespoke per strategy but typically will involve a structured solution with the bank, e.g. forward contracts, swaps etc.	Yes. Likely to be a combination of investment strategy and as a means to hedge investment / currency risk depending on the mixture combination of assets.	Yes, but mainly to hedge investment and currency risk – for example FX linked by assets.
Co-investment	Unlikely due to nature of underlying assets. Where used, this would likely be a parallel / bespoke vehicle such as a segregated managed account (SMA) or a separate AHC.	Potentially on the more illiquid assets but unlikely to be facilitated through the AHC. This potentially creates a co-mingled risk that the investor will typically wish to avoid. Where used, this would likely be a parallel / bespoke vehicle such as an SMA or a separate AHC.	Some investors may seek co-investment, but this is unlikely to be facilitated through the AHC. This potentially creates a co-mingled risk that the investor will typically wish to avoid. Where used this would likely be a parallel / bespoke vehicle such as an SMA or a separate AHC.

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

The implementation of BEPS Action 6 has led to greater focus within the investment management sector on whether there is a principal purpose and sufficient substance in their investment jurisdiction(s). A holding company structure which is aligned to either the jurisdiction of the fund or the management of the fund is instructive for many funds in ensuring they are BEPS compliant. This follows the Regional Investment Platform example[10], where it was highlighted that it is necessary to consider the context in which the investments are made when considering whether treaty benefits are available, including the reasons for establishing in that state and the investment functions and other activities carried out there. Furthermore, the Danmark cases with the milestone judgement focused on the concept of beneficial ownership and holding companies provides further impetus.

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

A substantial amount of portfolio management for credit funds with a European-based strategy is carried out in the UK. However, most often the credit fund and or AHCs will be located in another jurisdiction. If the UK were to introduce an AHC for credit funds, we believe that this could provide both direct and indirect economic benefits to the UK.

There would be some direct tax gained for the Exchequer from the activity of the vehicle. This would need to be commensurate with the economic activity undertaken by the AHC and be competitive with that applied by other jurisdictions to similar activity. For example, AHC structures in both Luxembourg and Ireland incur either zero tax or nominal tax through applying a margin basis.

More importantly, we believe that having a UK AHC would also create additional employment and commercial opportunities for asset management service providers who support the establishment and commercial operations of these structures. The provision of these ancillary services would create more commercial opportunities for these firms and support their ability to employ people. This would include administrators, fiduciaries, lawyers and accountants among others. This resulting economic activity also would translate to additional tax revenue to the UK.

Additional indirect benefits to the UK would be the boost to its attractiveness as a domicile to credit fund managers. Private credit has shown a 20% compound annual growth rate since 2000 and is on track to become a $1tn asset class by the end of 2020.[11] The majority of private credit assets dedicated to European strategies are invested through funds or AHCs in other EU jurisdictions. This creates compliance and operational challenges for those credit fund managers whose portfolio management teams are based in the UK.

[10] http://www.oecd.org/tax/treaties/Discussion-draft-non-CIV-examples.pdf

[11] *See* Figure 3, page 9 Financing the Economy 2017 – https://www.aima.org/uploads/assets/uploaded/b30be521-1092-479a-8d70f9d2db9d4ee7.pdf

A competitive and well-designed UK AHC would be attractive to credit fund managers for several reasons:

- Being in the same jurisdiction as the portfolio management team would alleviate any questions of substance and principal purpose from a regulatory perspective or in relation to tax (BEPS);
- Remove the need for UK managers to travel overseas for board meetings;
- Being in the same jurisdiction would promote investors' confidence in the investment structure and any reputational issues that can arise from cross-border structuring; and
- It would benefit from the UK's excellent tax treaty network.

We would therefore consider that a well-designed AHC would be particularly attractive for credit fund managers. This would support the UK's position as a leading asset management sector and allow it to better capitalise on the growth of private credit strategies that we expect.

It should be noted that while the introduction of AHCs for credit funds would likely add to the UK's attractiveness as an asset management centre, they would always be one of several considerations for asset managers when assessing their investment structures. The upcoming review of the UK fund regime, VAT treatment of fund management and the UK's future relationship with the European Union are just three substantive considerations that would also need to be accounted for, particularly for any asset managers looking to establish a UK AHC.

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

and

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

There are three main challenges within the existing tax rules that hinder the establishment of AHCs for credit funds. We expand on these below and summarise how the tax rules address some of these challenges for Luxembourg securitisation vehicles.

i. <u>Withholding tax on interest</u>

Preserving tax neutrality for investors is crucial for credit funds. It is essential that an AHC can obtain access to relevant domestic WHT exemptions or reduced WHT rates under an applicable tax treaty. As such, it is critical that any AHC framework adopted by the UK be fully compliant with current and developing standards established by the OECD. This ensures any investors in the fund do not receive a worse tax treatment than they would have received had they held the investment directly and reduces the administrative burden.

While this is possible in the UK under existing rules, it is costly and cumbersome in comparison to other jurisdictions. For example, listing loan notes from the AHC on a recognised exchange ensures that the interest payments are exempt from UK WHT under the Quoted Eurobond Exemption is an established and sanctioned route, however, the upfront listing costs (starting at around £25k per loan), as well as annual compliance costs is simply unattractive from an economic standpoint given alternatives in Luxembourg and the Netherlands incur no such costs. Public discussion about the appropriateness of the Eurobond exemption also creates raises questions about its longevity which creates uncertainty and hinders longer term planning. Furthermore, while the UK has an extensive tax treaty network, the assessment and administration of tax treaty claims for each fund investor can be time-consuming and resource intensive.

ii. Entity level taxation

The activity undertaken by an AHC in a credit strategy is often nominal in relation to the performance of the investment and typically less than might be the case with other asset classes. Therefore, any related tax treatment would be expected to be commensurate with this low level of activity while also consistent with purpose and substance standards under OECD principles. For example, a typical taxable margin in Luxembourg is likely to be between 5bps and 50bps depending upon the type of debt strategy and the principal amount of the notes. This can be calculated using a well-established transfer pricing analysis considering an arm's length premium for the equity at risk and an arm's length handling fee for undertaking the financing activities.

For funds using an AHC for a distressed lending strategy, the tax treatment of the receipt of loan principal above the acquisition price would potentially create a disproportionate tax treatment. It is usual for AHCs acquiring distressed loans to be funded with a combination of equity, fixed rate loans and a significant Profit Participating Loan (PPL). The receipt of any principal above the acquisition price (often termed "pull-to-par") would however be taxed under the loan relationship rules[12] in the UK, creating a taxable credit in the AHC. This would leave the AHC with a substantial taxable amount which would be disproportionate in relation to its limited activities. While other jurisdictions such as Luxembourg permit a tax deduction for all obligations to creditors and shareholders on its loans and shares, it is not possible to structure a similar capital structure in the UK as:

- Under the securitisation tax regime as a note-issuing company it would need to issue the notes wholly or mainly to independent persons, but from a commercial standpoint it would be necessary for all instruments issued by the AHC to be held by the fund which would not be regarded as an independent person;
- None of the other forms of securitisation company within the regulations would meet the commercial objectives of an AHC within the context of a credit fund; and
- Any repurchase of shares by a UK company is generally treated as a dividend for UK income tax purposes such that the aim of preserving the underlying character of pull-to-par gains would be defeated.

[12] Any payment on a PPL above its initial principal would be a distribution for UK corporation tax payments under section 1000(1)(F) due to it being a special security under section 1015 CTA2010.

iii. Hybrid mismatch rules

Uncertainty regarding the potential application of the UK hybrid mismatch rules because of how the fund partnerships and the AHC are viewed in certain investor jurisdictions (e.g. the US) is another challenge for credit funds. Restrictions of the deductibility of interest expenses (and potentially other external costs) at the level of the UK AHC will have an adverse consequence to the net return to those investors and should be considered in the context of preserving tax neutrality as compared to direct investment.

Making an assessment on the applicability of the hybrid rules is an onerous exercise even in instances where the rules do not apply. The potential interaction with other rules pertaining to deductibility of interest expenses, such as the Corporate Interest Restriction rules also creates further challenges.

Luxembourg tax and accounting treatment for AHCs

Under the Luxembourg Securitisation Vehicle (SV) regime, the public accounts of the AHC can use either IFRS or Luxembourg GAAP but tax returns are prepared under Luxembourg GAAP. Luxembourg GAAP provides, broadly, that interest is recorded on an accruals basis and fair value is the lower of cost or cost less impairment. There is no true fair value requirement.

The SV is outside transfer pricing requirements, however, managers may choose to price and retain a margin which would be subject to tax. The SVs are typically financed by a mix of equity and debt (majority debt). The key tax principles provide:

- Interest on debt is fully tax deductible and there is no WHT;
- Interest quantum is priced per transfer pricing methodology applied to the specific SV;
- Excess profits can be returned through dividends declared to shareholders (which are tax deductible) and there is no Luxembourg WHT; and
- Exemption from VAT on management services.

Capital repayments can be made through repayments of loan principal and any capital gains can be either repatriated via dividend deduction or share repurchase (whose revaluation for repurchase is also tax deductible). As with UK companies, compliance with corporate interest restriction and hybrid rules also needs to be considered however these are generally seen as manageable. In particular the implementation of the hybrid rules in Luxembourg are seen as pragmatic in how they have adopted a safe harbour where investors are presumed not to be acting together if their shareholding or entitlement to profits in an investment fund is less than 10%.

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

The implementation of BEPS Action 6 has led to greater focus within the investment management sector on whether there is a principal purpose and sufficient substance in the jurisdiction(s) where the investing entity is located. A holding company structure which is aligned to the jurisdiction of either the fund or the management of the fund, is constructive for many funds in ensuring they are BEPS compliant across jurisdictions. This continues to be a developing area of law and practice, and we believe it is critical for HMT to factor both current and developing industry practices in designing its AHC regime.

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

We would only note that any reforms to existing tax rules to improve the attractiveness of the UK as an AHC location will always be assessed alongside other commercial factors and the broader UK asset management framework by both asset managers and their investors.

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

We would suggest two main approaches to addressing the challenges identified under question four. These are either to amend the UK securitisation rules or to create a new regime for AHCs.

While amending the securitisation rules has the attraction of building on existing practices, we do not believe it would be possible to do so in a way which simultaneously provided the flexibility required by credit funds, while also meeting the Government's policy objectives with regard to the broader use of the rules by non-credit funds. Therefore, we believe that a new regime for AHCs used by credit funds would be the most appropriate option.

With that being said, a new regime may bear similarities to the UK securitisation rules in the sense that there would be separate legislation and regulations to govern the regime , and many of the underlying principles should be adopted in an AHC context for credit funds.

It will be important to establish the entry criteria for the regime and for these to be straightforward for taxpayers to understand and apply. To qualify, we suggest that the credit AHC be entirely held by "qualifying investors" plus (if relevant) "qualifying management". We set out more details on the relevant eligibility criteria under Q9.

The new regime would have the following features:

- **Subject to tax on a margin**: We anticipate that the AHC would be subject to corporation tax on a margin. The amount taxable would effectively be the margin from loan relationships and derivative contracts calculated in line with accounting principles. Determining the appropriate margin would be on established transfer pricing methodologies that would be set out in either legislation, guidance of a combination of the two. The Luxembourg circular (article 56bis) provides that intragroup financing transactions must be performed on arm's length terms, however in reality a Luxembourg AHC may be outside the scope of the Circular as they are not lending to associated enterprises. Typically, an AHC in Luxembourg will be remunerated based on a cost-plus basis for the back to back lending activity and an arm's length risk premium for the limited equity at risk. The rest of the return will be transferred to the Fund which is assuming the investment risks. However, the absence of written guidance from the

Luxembourg tax authorities on the transfer pricing approach to be taken in relation to Luxembourg AHC means that there are different approaches to this in the market. From a UK perspective, we would expect the loan from the Fund to the UK AHC to fall within the UK transfer pricing rules. To reduce uncertainty for taxpayers we would propose that the treatment of the debt:equity ratio and the rate of interest is determined by a clear methodology that determines what the appropriate margin should be. Providing taxpayers with a sufficient certainty as to what can be expected in this respect will be necessary to foster confidence in a UK AHC regime. Furthermore, access to the UK's double tax treaties will also be a necessary attribute for any UK AHC. Therefore, the AHC it will need to be recognised as a taxable entity without too many special exemptions that could erode its status.

- **Revise UK anti-hybrid rules:** It would be necessary to consider the interaction between how any future UK AHC regime would interact with the UK anti-hybrid rules, which are under separate consultation. For a UK AHC to be attractive, it will be necessary for the UK anti-hybrid rules to be aligned with ATAD II such that they are only relevant when the hybridity is the cause of non-inclusion. The acting together rules should also be widened so that investors are not treated as acting together by virtue of being in partnership. Switching off the hybrid rules off could create a risk that other jurisdictions would apply the imported mismatch rules so we would recommend clarifying the rules instead of disapplying them entirely.

- **Removing WHT on interest payment made by the AHC:** This could be achieved by removing the WHT obligation on payments to non-individuals and would cover both interest paid to the parent fund vehicle but also to third party lenders. This approach has been successfully implemented in jurisdictions such as Germany, France, Sweden, Finland and Norway. Any exemption focused at the level of the fund would be an alternative approach, however, our members' experience is that such an exemption is often more complicated and onerous to apply in practice. Removing the WHT obligation on payments to non-individuals would provide taxpayers with more certainty without creating excessive risk to the Exchequer or being inconsistent with UK tax policy more generally.

- **Treatment of capital gains:** While credit strategies do not typically target capital gains, these can occur depending on the circumstances of the borrower or broader economic environment. For example, it may be necessary for debt for equity exchanges to take place or to enforce security or take possession of collateral to protect the investors' interests. Some strategies may also see debt purchased at a discount. These types of scenarios are likely to be more prevalent during times of economic turbulence such as we are seeing in response to the public health restrictions imposed to mitigate the impact of COVID-19. Recent months have seen a trend towards opportunistic credit funds being raised by private credit fund managers in response to investor demand for more flexible credit strategies. In these circumstances, the capital gains treatment should be retained for the proportion of the returns provided to investors rather than have this treated as income. If this treatment is not retained, then investors and asset managers will have less certainty about the likely return profile. This will likely render any UK AHC as unviable, irrespective of any additional benefits they might provide. There are several ways this could be achieved. Introducing a new exemption for a security issued by an AHC into the deeply discounted security rules could preserve the capital gains treatment rather than see this treated as income. Alternatively, HMT and HMRC could consider widening the SSE or allowing distributions in capital form on a debt instrument. It is our understanding that these proposals would be consistent with the approaches being considered in relation to the use of AHCs by private equity businesses. Having a similar approach may be a simpler method of introducing any changes to support a UK AHC regime while also providing greater certainty to taxpayers.

- **Extension of Substantial Shareholding Exemption (SSE):** Where the AHC has small equity stakes and warrants, there would need to be a way in which it could qualify for the SSE. The Luxembourg participation exemption uses a monetary investment amount of €6m, which we believe could be adopted here if a broader SSE regime is pursued. In a UK context this could include extending the definition of a "substantial shareholding" for circumstances where the AHC holds shares, interests in shares or assets related to shares in another company and has made an investment of a defined amount in credit assets relating to that company or a member of its group. A simplification of the trading company test, which we understand other industry bodies may be requesting, would further enhance the effectiveness of this reform.

- **Amend deemed distribution rules:** In line with the securitisation rules, we suggest that the credit AHC rules would switch off the deemed distribution rules. This would allow AHC to be funded by profit participating debt.

- **VAT:** The supply of management services by the UK manager to the general partner acting on behalf of the fund will be taxable unless the fund meets the definition of a special investment fund (SIF). Typically, credit fund vehicles, which are often set up as AIFs, will not qualify as SIFs but the manager will usually be VAT-grouped with the general partner of the fund vehicle so that supplies between the two are disregarded for VAT purposes. For transactions involving an AHC, the fund will usually make VAT-exempt loans to the AHC, which in turn will transact with third parties. The majority of VAT-bearing costs are therefore typically incurred by the fund and the manager, rather than by the AHC. the VAT treatment for any new UK AHC would be needed to make this a realistic option for private credit fund managers when compared to AHCs established in other jurisdictions. The annex to this letter provides additional detail about typical VAT flows for private credit funds using UK and other common structures.

We recognise that each of these proposals will need to be assessed by HMT and HMRC both on their own merits and collectively. The review of the UK funds regime and VAT on fund management also means that they would need to be reassessed in light of any additional reforms which may flow from these reviews. We would strongly encourage HMT and HMRC to ensure that any further AHC proposals are aligned with any broader changes to make a UK AHC a competitive and attractive option for fund investors and investment managers.

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

As noted above, we believe that a bespoke regime would be needed for AHCs. Any consideration of eligibility would need to provide enough flexibility to capture the different investment and co-investment structures that are commonly used as part of credit strategies. If eligibility is defined too narrowly then the AHC will be of limited use to credit funds and their investors.

We anticipate that on satisfying the eligibility criteria, the framework set out in the regulations would apply to a UK resident AHC, and that this would be entirely held by "qualifying investors" plus where relevant "qualifying management". For these purposes, an investor would be a "qualifying investor" if it were:

- an alternative investment fund (AIF);
- a collective investment scheme (CIS); or
- held directly by a "qualifying investor" that would be established via a white list format (e.g. UK and non-UK pension funds)

The advantage of this approach would be that this would draw on established and familiar definitions, such as the AIF definition from the AIFM Directive. This states that an AIF is "any collective investment undertaking, including investment compartments thereof, which raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors and which does not require authorisation pursuant to the UCITS Directive."

The concept of "qualifying management" would allow the fund management house that manages the relevant qualifying investor (or the assets of the qualifying investor that are being held by the credit AHC) to hold co-investment interests or carried interest that give it an ownership stake in the AHC. This could also be defined by reference to established and familiar definitions such as AIFMs or US Registered Investment Advisors (RIAs) but we would welcome further discussions with HMT on this point.

A secondary qualification might be needed to ensure these bespoke rules for a credit AHC are only accessible by those with credit assets. Such criteria might simply require more than 50% of the total value of assets invested in by the AHC to be credit assets for to qualify as a credit AHC. This would help guard against any potential risk to the Exchequer for non-qualifying activity to be placed in an AHC wrapper.

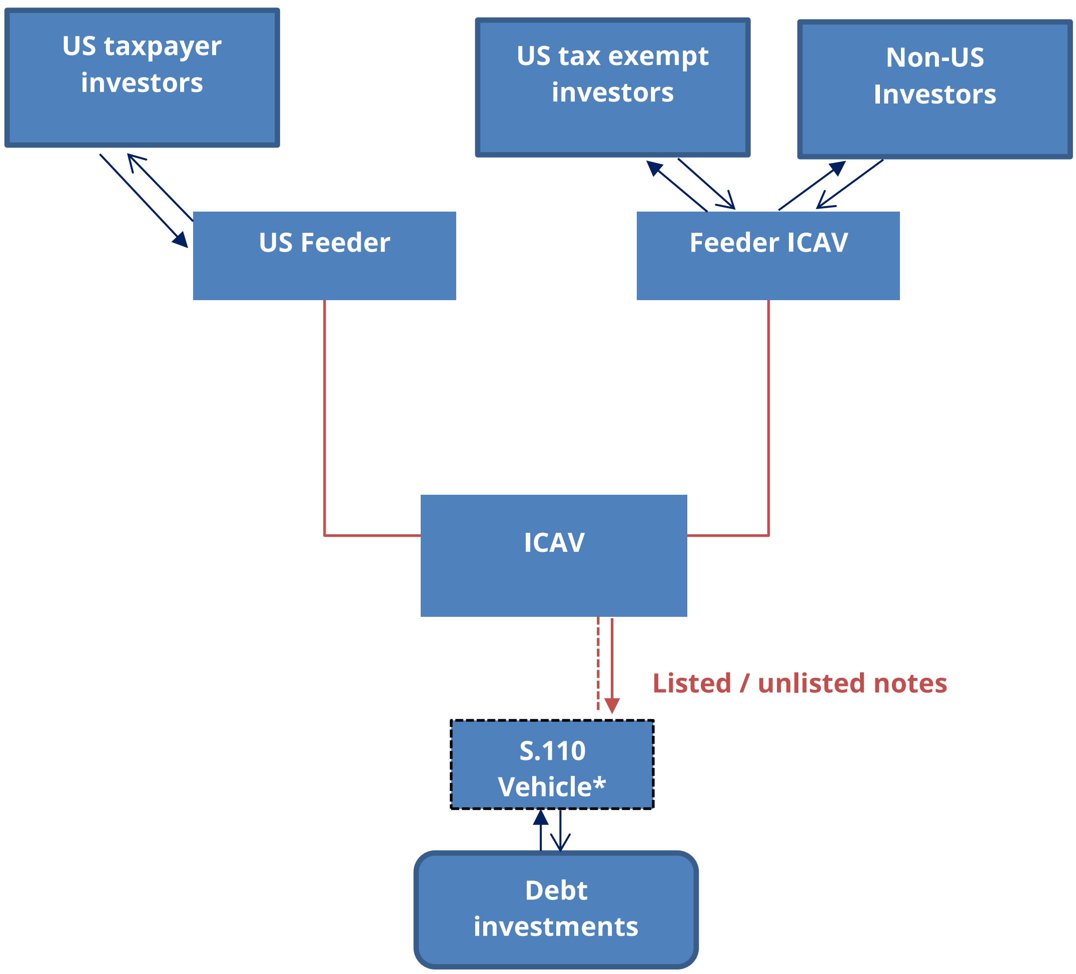
In the current environment it is likely that some credit funds will also have some equity holdings, and many funds invest equally in debt and equity strategies. It will be necessary to ensure that there is sufficient flexibility in the regime to ensure that these types of investment managers are not restricted from accessing the regime. We would also propose that an advanced clearance regime is set-up to provide taxpayers with greater certainty in more complex or difficult circumstances. This will also support HMT and HMRC's understanding of how AHCs are being used.

Annex 2 - Typical Luxembourg and Irish AHC structures

	Luxembourg – Securitisation Vehicle	Luxembourg - Soparfi	Ireland – S.110 company
Tax	Fully taxable company, but all payments (including dividends to shareholders) are tax deductible. A typical Luxembourg SV is financed via profit participating notes to allow regular income distribution, but also allows deduction of equity retained profit so should result in a nil taxable profit. While there is no requirement to pay a margin, certain funds choose to pay tax on a margin to demonstrate commercial substance.	Fully taxable company which is subject to transfer pricing requirements to retain commercial margin. Soparfi's typically issue income sharing loans or notes, which track interest income receipts (subject to TP margin), to fund investments alongside minimum equity at risk requirements.	Subject to any adjustments required or authorised by law, an Irish SPV's profit for tax purposes follows the accounting treatment. With the issuance of a profit participating security, this results in little or no profit being left in an Irish SPV, except a minimum amount for corporate benefit purposes. Any residual profit is taxed at a rate of 25% under the investment company regime.
TP	No TP requirement.	TP requirement – subject to corporate tax on retained profit.	No TP requirement, provided structured as orphan companies.
WHT	No WHT on payments of interest under debt securities issued by a Luxembourg SV but possible application of WHT on interest paid to certain non-Luxembourg resident investors (individuals and certain types of entities called "residual entities"). No WHT on payments to shareholders, either in dividend or share repurchase form.	No WHT on payment of interest on ISLs. Dividend WHT applies on equity distributions but can ordinarily be managed via share class liquidations.	20% WHT on interest paid by Irish SPVs on notes or loan facilities unless an exemption applies, but the quoted Eurobond exemption or wholesale debt instruments exempt WHT in certain circumstances, plus EU Interest & Royalties Directive and treaty exemptions. Additional domestic exemptions apply.
VAT	"Management" services are exempt from Luxembourg	Subject to VAT unless an AIF.	All collateral management fees and corporate

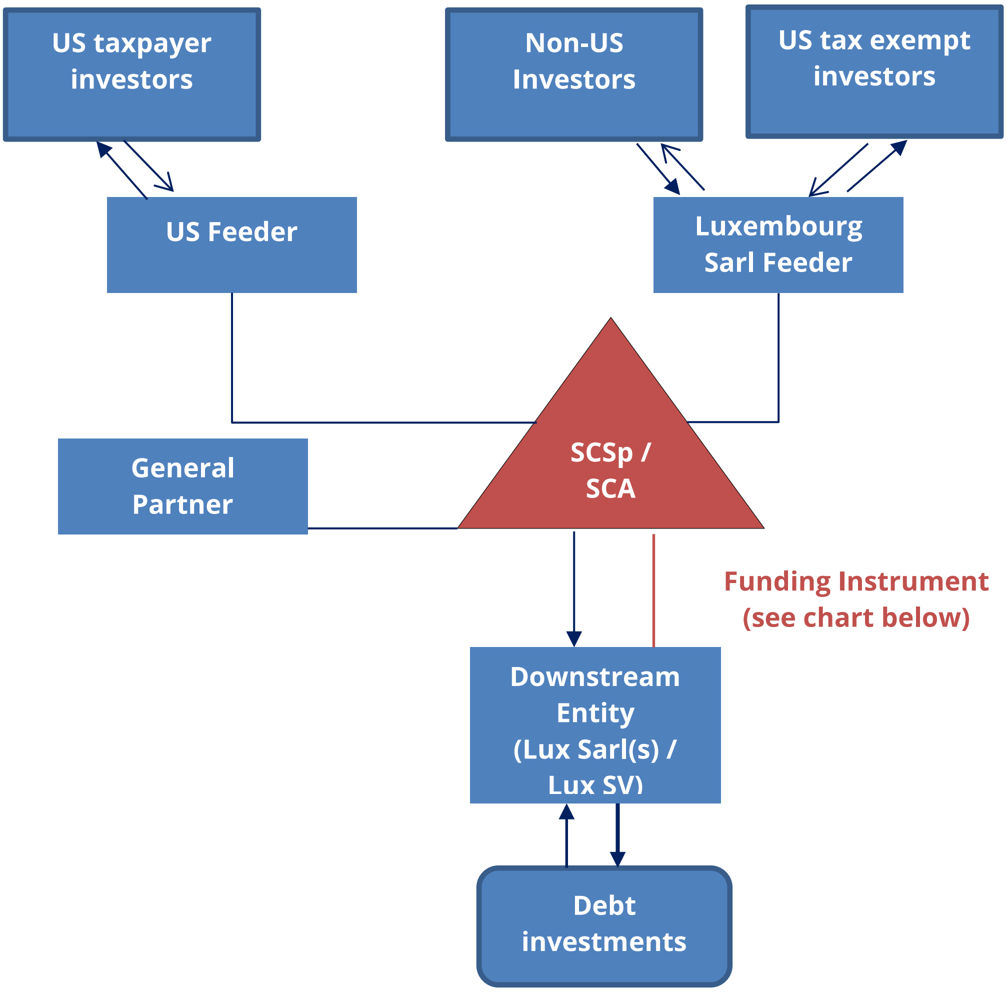
	VAT and collateral management fees and investment advisory fees may be considered to be covered by this exemption.		administration services will generally be VAT exempt on a statutory basis.

Example corporate structure – Ireland



*S.110 vehicle may be optional and depends on the extent to which an ICAV can benefit from double tax treaties in a borrower jurisdiction.

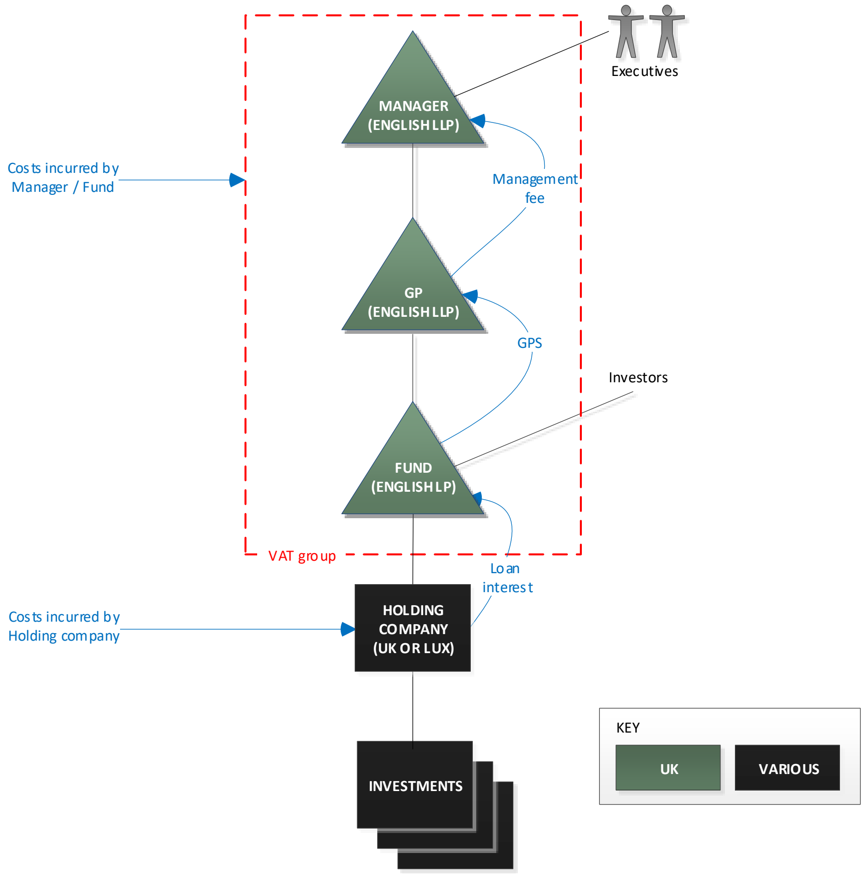
Example partnership structure – Luxembourg



PPL / Swaps	Listed note	Convertible note
These are used to ensure flow-through of income / profit to the fund but do not provide any particular protection in relation to “beneficial ownership” for treaty relief purposes. As such, consideration should be given to either a listed note or a convertible note where appropriate.	Listed notes which satisfy the quoted Eurobond definition should allow full withholding tax relief on UK source interest payments from UK borrowers. Both a Luxembourg SV and a Luxembourg Sarl are able to issue listed notes.	A convertible note structure would be suitable for a distressed debt fund strategy in which investors expect to receive capital gains returns – it would offer the most tax efficient method of extracting capital and principal. A convertible note can also enhance tax treaty eligibility, as it strengthens the beneficial ownership argument to the underlying interest because there is no need to distribute income to obtain a tax deduction.

Annex 3 - Typical VAT flows for credit fund structures

Example UK structure



Current position for a UK holding company

- Supplies made by a UK holding company will usually fall under one of the finance VAT exemptions and will therefore only give the UK holding company entitlement to input tax recovery to the extent that the recipients belong outside the EU. A UK holding company is therefore typically unable to recover much, if any, of its input tax but this is not usually a material concern.

- Loans made by the fund to a UK holding company do not give the fund vehicle or the manager an entitlement to input tax recovery.

- If a UK holding company can join the VAT group then any supplies made by a UK holding company to non-EU counterparties should give the fund and the manager an entitlement to input tax recovery. However, a UK holding company will typically make few supplies to non-EU counterparties, if any.

Potential impact of Brexit

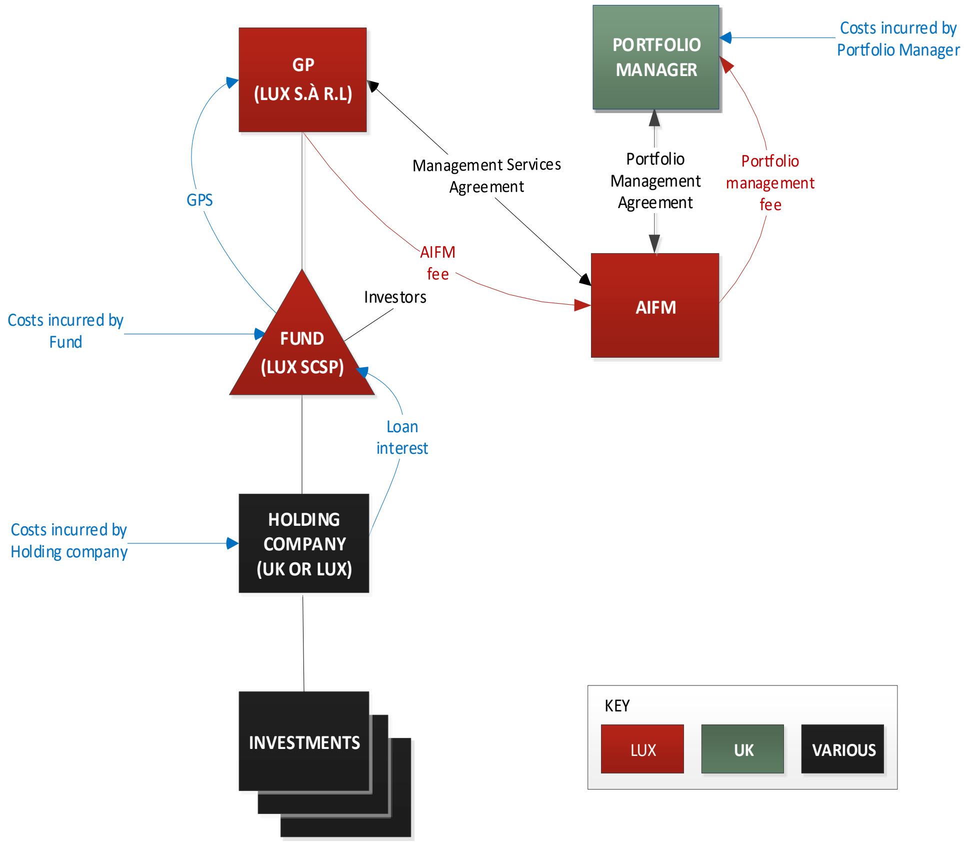
- Following the end of the Brexit transitional period, and depending on the terms of any agreement between the UK and the EU, it is possible that supplies made by a UK holding company to recipients belonging in the EU will give it an entitlement to input tax recovery.

- For any such change to benefit the fund and the manager, a UK holding company would need to join the manager/fund VAT group. If it does not join the VAT group then the manager and the fund will typically be unable to recover any VAT on their costs as the main (and possibly only) supplies made out of the VAT group are UK to UK VAT-exempt loans made by the fund to the UK holding company.

Current position for a Luxembourg holding company

- If loans made to EU recipients give UK lenders the right to input tax recovery as a result of Brexit then having a Lux holding company rather than a UK holding company should in principle enable the manager and fund to recover all of the VAT incurred on their costs.

Example Luxembourg structure



Most credit funds will qualify as SIFs under Luxembourg law. The portfolio manager's (PM's) supplies to the AIFM are usually exempt from Luxembourg VAT. They nonetheless give the PM the right to recover UK VAT incurred on its costs because the fund is not considered to be a SIF under the UK rules. The fund will usually make VAT-exempt loans to holding company, which in turn transacts with third parties.

Current position for a UK holding company

- Supplies made by a UK holding company will usually fall under one of the finance VAT exemptions and will therefore only give a UK holding company an entitlement to input tax recovery if the recipient of the supply belongs outside of the EU.

- The PM should be entitled to recover input tax on its costs because it supplies management services in respect of a fund that is not a SIF under the UK rules.

- The fund will typically be unable to recover VAT on its costs because it supplies VAT-exempt loans to a UK recipient (UK holding company).

Potential impact of Brexit

- Following the end of the Brexit transitional period, and depending on the terms of any agreement between the UK and the EU, it is possible that supplies made by a UK holding company to EU recipients could give a UK holding company entitlement to input tax recovery. This is unlikely to be of significant benefit, however, because the UK Hodco is unlikely to incur significant amounts of the VAT.

- More significantly, the fund may achieve full recovery of Luxembourg VAT on its costs by virtue of the loans granted to a UK holding company (assuming that any change in the VAT treatment of financial services supplied between the UK and EU would work reciprocally).

Current position for Luxembourg holding companies

- The position is largely the same as for a UK holding company:

  - A Luxembourg holding company is typically unable to recover much, if any, of the (Luxembourg) VAT it incurs on its costs but does not typically incur material amounts of VAT. Where the holding company is a securitisation vehicle that qualifies as a SIF for Luxembourg VAT purposes, management services supplied to it are exempt from VAT.

  - The fund is typically unable to recover (Luxembourg) VAT on its costs

  - The PM is entitled to full UK VAT recovery but this results from the UK's definition of a SIF, rather than the status or location of a holding company.

Potential impact of Brexit

- A Luxembourg holding company may be entitled to recover Luxembourg VAT incurred on its costs to the extent it makes supplies to UK counterparties. However, this is unlikely to be of material benefit.