Analysis

QAHCs and UK securitisation companies: awkward bedfellows?

Speed read

The qualifying asset holding company (QAHC) regime is shaping up to become a genuine competitor to Luxembourg and Irish holding companies. Previously, other than a normally taxed UK company, the main UK asset holding company option for loans and other financial products was a UK securitisation company taxed under the Taxation of Securitisation Companies Regulations, SI 2006/3296 (TSCR 2006). However, the TSCR 2006 rules give rise to some practical difficulties when applied outside the context of a more traditional securitisation (for example, within a credit fund). The QAHC regime is broader and potentially simpler than the securitisation regime, but comes with its own challenges, and we are now left with two regimes that sit awkwardly beside (and slightly on top of) one another.

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UK securitisation company regime

The use of a note-issuing securitisation company within the TSCR 2006 (a 'UKSV') is now well established. In a typical securitisation, the UKSV issues notes to investors to fund the acquisition of financial assets yielding reliable and predictable cash flows (such as mortgage, lease, trade, and credit card receivables) from an originator. The notes are limited in recourse to, and benefit from security over, the underlying financial assets, and are typically tranched into senior and junior classes. The eligibility conditions in the TSCR 2006 were crafted with these structures in mind. However, given the recent shift from traditional bank lending towards credit funds and other non-bank lenders, coupled with the increasing global focus on substance, the UKSV has more recently been considered as a potential alternative to the Irish section 110 company or Luxembourg S.à.r.l in non-securitisation structures. In this context, the TSCR 2006 can give rise to some practical difficulties. Before the QAHC, it might have been worth putting up with these to avoid the difficulties associated with using a 'normally-taxed' UK company to hold a moving portfolio of loans in a tax efficient manner (given the inability to claim deductions for profit participating debt). Going forwards, however, the UKSV is more likely be confined to the structures for which it was created.

TSCR 2006

Where a company meets the conditions in the TSCR 2006, it will automatically fall within the securitisation tax regime: no election needs to be made. The UKSV will be taken out of the normal corporation tax rules (reg 14(4)) and only subject to corporation tax on its 'retained profit' (regs 10 and 14). Recent amendments have provided further tax benefits, including:

- a general exemption from counteraction under the UK anti-hybrid rules (TIOPA 2010 s 259NEZA);
- an exemption from UK stamp taxes on the transfer of profit participating loans issued by a UKSV (Securitisation Companies and Qualifying Transformer Vehicles (Exemption from Stamp Duties) Regulations, SI 2022/464) (such loans are typical in UKSV structures, due in part to the need to comply with the 'payments condition'); and
- an exemption from UK withholding tax on annual payments made by a UKSV (TSCR 2006, reg 14A), which may arise in respect of the profit participating loans referred to above. However, a UKSV is still subject to the normal withholding tax rules in relation to interest, the result of which is that the UKSV's notes are often listed so as to benefit from the quoted Eurobond exemption (ITA 2007 s 882).

Going forwards, however, the UKSV is more likely be confined to the structures for which it was created

In order to fall within the scope of the TSCR 2006, a note-issuing company must, broadly, meet the following conditions:

- the company must issue notes with an aggregate value of at least £5m (TSCR 2006, reg 5(4)) (reduced from £10m since 17 May 2022);
- that issue of notes must be part of a 'capital market arrangement' as defined in Insolvency Act 1986 Sch 2A para 1 (TSCR 2006, reg 5(3));
- the notes must be wholly or mainly issued to 'independent persons' (TSCR 2006, reg 5(3)) (the 'independent persons condition'); and
- the company can only undertake certain prescribed activities (principally acquiring, holding and managing financial assets as security for the issued notes) aside from 'incidental activities' (TSCR 2006, reg 5(5)) (the 'activity condition'). 'Financial assets' has the meaning it has for generally accepted accounting purposes, but expressly excludes shares and certain derivatives where the underlying subject matter includes shares or land (TSCR 2006, reg 9A).

A UKSV must not have (or have ever had) an 'unallowable purpose', and must comply with the 'payments condition', i.e. it must (broadly) pay out all income (other than retained profit and amounts reasonably required to maintain creditworthiness and provide for losses or expenses) within 18 months of the end of the accounting period of the receipt (TSCR 2006, reg 11).

The QAHC regime

In contrast to the UKSV, the QAHC has been specifically designed for use as an asset holding company in the fund context: it can hold a much broader range of assets and is not subject to many of the limitations noted above. That said, it seems entirely feasible to use a QAHC to hold the sort of receivables typically held by a UKSV, at least where they throw off loan relationship credits, provided you have the right sort of investors. In practice though, it seems unlikely that there will be much appetite to move more traditional securitisations into a QAHC given how established the securitisation market is. In other cases where the UKSV may once have been a contender to non-UK vehicles, the QAHC is likely to be far more attractive.

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The QAHC eligibility criteria have been discussed in detail in other articles in this journal (see, for example, 'The UK's new qualifying asset holding company regime' (Emily Clark, Elena Rowlands & Ian Zeider), *Tax Journal*, 19 November 2021) and so we do not propose to discuss each in depth here. However, it is worth noting the ownership condition which, in practice, presents the principal barrier to entry. The ownership condition is a negative test requiring that no more than 30% of 'relevant interests' in the QAHC are held by non-Category A ('bad') investors. In many cases, this will be satisfied by the QAHC being held by a 'qualifying fund'. Broadly, this is a 'fund' (either a collective investment scheme or alternative investment fund ('AIF') (each as defined for regulatory purposes)), which: (i) satisfies the 'genuine diversity of ownership' test (borrowed from the offshore funds rules); (ii) meets a non-closeness test; or (iii) is at least 70% controlled by Category A investors. We understand HMRC is consulting on the scope of this requirement and hope this leads to changes that deal with some common stumbling blocks (see 'QAHC changes: further refinements' (Rhiannon Kinghall Were & Damien Crossley), *Tax Journal*, 26 July 2022). It is also worth noting that, unlike the securitisation regime, it is necessary to elect into the regime by submitting a notification to HMRC, so it is not possible to accidentally fall into it.

Whilst the overall tax position of a QAHC is likely to be similar to that of a UKSV (i.e. tax on a small margin), the regimes get to this result in very different ways. Instead of disapplying general corporation tax rules, the QAHC regime prevents 'relevant distributions' out of the assets of the QAHC in respect of (essentially) profit participating debt from being treated as distributions for UK tax purposes, provided the QAHC is a party to those securities for the purposes of its QAHC ring-fence business (FA 2022 Sch 2 para 44) – i.e. it allows the QAHC to issue deductible profit participating debt, which offsets loan relationship credits arising to the QAHC, subject to a transfer priced margin (and subject to the overlay of anti-avoidance rules such as the corporate interest restriction and the anti-hybrid rules, to the extent not specifically disapplied).

Other benefits include:

- A general exemption from the obligation to withhold tax on interest payments made as part of the QAHC's ring-fence business (ITA 2007 s 888DA). This is far wider than the withholding tax exemption afforded to UKSVs, which is limited to annual payments.
- Share buy-back provisions that generally treat payments made by a QAHC on the redemption, repayment or purchase of its own shares as subject to the capital gains regime (rather than income distributions on amounts in excess of (broadly) the original issue price). This is particularly important for retail investors and (if applicable) in the context of carried interest where UK holders usually have a strong preference for capital gains tax treatment. By contrast, since an investor would typically only hold debt (and not equity) in the UKSV due to the need to comply with the independent persons condition, they would generally only be entitled to receive income amounts.
- A partial exemption from the hybrid rules in respect of hybrid financial instruments. However, unlike UKSVs, the exemption from the anti-hybrid rules for QAHCs does not extend beyond hybrid instruments. Counteractions under the hybrid rules may therefore still arise in respect of QAHC structures with US investors where check-the-box elections would typically be made. This is somewhat unsatisfactory, particularly given the overlapping aims of the QAHC and UKSV regimes, and the fact that many fund structures that would seek to make use of QAHCs are likely to have US tax sensitivities.
- The ability to hold shares and, helpfully, a blanket exemption on gains arising from shares, without the restrictions associated with the UK's substantial shareholding exemption.

> The QAHC's ownership condition presents the principal barrier to entry

Some practical difficulties

The UKSV

Whilst the UKSV clearly has a number of benefits, some of the conditions of the securitisation company regime make its use in a non-securitisation context less straightforward.

For example, the activity condition clearly limits the range of assets which a UKSV can hold, and can be problematic in an enforcement situation. In a typical securitisation, this is usually dealt with by requiring the originator to repurchase doubtful or bad receivables. However, in the context of a distressed bilateral loan, an enforcement would often involve calling upon share charges. Given that shares are expressly excluded from being financial assets for these purposes, the UKSV cannot itself acquire the shares subject to the charge and must instead nominate another entity to do so.

Complexities can also arise where the UKSV subsequently wishes to obtain additional liquidity. Subsequent note issuances must either form part of the existing capital market arrangement, or have a value of at least £5m. Other forms of financing (such as a revolving bank loan or repo arrangements) generally need to be regarded as 'incidental'. It may also be difficult for the UKSV to grant meaningful security over its assets to anyone other than the noteholders (as the UKSV's financial assets must continue to be held as security for the notes issued by the UKSV).

There have also been concerns around the use of a UKSV for loan origination, principally due to the reference in HMRC's *Corporate Finance Manual* at CFM72410 which states that a UKSV should not carry on a trade, and the uncertainty around whether loan origination activities constitute trading (however, to some extent, these have been allayed due to a helpful example in the new guidance on QAHCs in HMRC's *Investment Funds Manual* at IFM40260).

Given the above, it is clear that the UKSV is (unsurprisingly, given its history) less well suited to being used as a holding company within an investment fund structure than the QAHC. However, the QAHC regime comes with some of its own practical limitations.

The QAHC

Whilst limited by its own 'activity condition' (broadly, that its main activity is the carrying on of investment business and that any other activities are not carried out to any substantial extent), the range of assets a QAHC is permitted to hold is much broader and, crucially, includes shares. Absent also is the requirement for the assets of the QAHC to be held as security for the debt issued by the QAHC which, unlike notes issued by a UKSV, can be issued in any amount and at various stages.

On the other hand, QAHCs do not benefit from the stamp taxes exemption enjoyed by UKSVs on their issued debt securities. Given that profit participating loans are unlikely to be considered exempt loan capital in FA 1986 s 79(4), transfers of debt issued by the QAHC will likely be subject to UK stamp taxes. While transfers of the QAHC's loans may be uncommon where the QAHC is held by a qualifying fund (which will often be the case), this may still be relevant in the context of secondaries transactions if the QAHC is rolled into a continuation fund, depending on how this is structured. Moreover, a transfer of the limited partnership interest in the qualifying fund could technically be subject to stamp duty in certain circumstances, albeit limited (broadly) to the stamp duty that would be payable on a transfer of the underlying stock or marketable securities held by the partnership (FA 2003 ss 31–33). To mitigate the risk of stamp taxes, one might consider using a non-UK incorporated QAHC and maintaining the register outside of the UK. However, this begs the question as to why there is not simply a blanket exemption from stamp taxes on securities of the QAHC.

The regulatory overlay should also not be overlooked when considering whether to use a QAHC. Should your QAHC be treated as an AIF, for example, this would attract a notable compliance burden. It can be surprisingly hard to get a straight answer on whether something is an AIF or not, but the risk seems lower (but not nil) if your QAHC is used as a holding company beneath a fund rather than as a fund entity itself. This may put the QAHC at a disadvantage when comparing potential holding company options. For example, we understand that the Irish Central Bank has confirmed that Irish debt-issuing DACs are not AIFs. It is also worth noting that a 'securitisation company' means different things to tax and regulatory lawyers. If you were to use a QAHC in place of a UKSV (particularly if debt issued by the QAHC were to be vertically tranched into different layers of risk), you will need to consider whether your QAHC is a securitisation company for regulatory purposes. Such status will again bring with it onerous reporting obligations, and the need to comply with risk retention rules.

Whilst a somewhat technical point, it is also worth noting the effect of the Partnership Act 1890 s 3 on profit participating debt of the type likely to be issued by a QAHC. This section seems to have the effect of subordinating the claims of lenders under such loans beneath those of all other creditors. Despite the Act's title, this seems to extend to corporate debtors too. While, in many situations, the profit participating loan is equivalent to equity and so this subordination should not be problematic, this may nevertheless come as a surprise to some holders of profit participating debt.

A theoretical UKSV QAHC?

As both QAHCs and UKSVs have their pros and cons (although in the round, in the fund context at least, the QAHC is the clear favourite), this raises the question of whether a company can be both?

At present, there does not seem to be anything in either regime which would prevent this, although we understand the interaction between the regimes is something HMRC have been considering since the consultation phase. Given the need to opt into the QAHC regime and the fairly prescriptive rules to become a UKSV, it seems unlikely you would accidentally find yourself in both. However, with the right set of facts, it seems possible (at least in theory) to structure a company in such a manner that it satisfies the conditions for both regimes. In that case, it seems your UKSV QAHC would:

- only be taxed on its retained profit rather than under general corporation tax rules (given TSCR 2006, reg 14(4));
- benefit from the blanket disapplication of anti-hybrid rules;
- benefit from an exemption from the obligation to withhold on annual payments as well as on payments of interest under the profit participating loans issued by the company; and
- benefit from the blanket exemption from stamp taxes on the transfer of those loans.

One of the more challenging hurdles to this may be navigating both the independent persons condition and the QAHC ownership condition. The ownership condition in the QAHC regime is determined by reference to entitlements to distributions to 'equity holders' (which should include holders of profit participating notes by virtue of the definition of 'equity holders' at CTA 2010 s 158, as well as holders of shares), as well as to voting power (FA 2022 Sch 2 para 3(2)). However, as 'relevant distributions' are not treated as distributions for the purposes of the Corporation Tax Acts, though guidance in HMRC's *Investment Funds Manual* at IFM40200 clearly envisages the economic tests being applied by reference to debt with equity-like features, query on the wording of the legislation whether interest payments in respect of the profit participating loans issued by the QAHC should technically be counted as distributions for the purposes of FA 2022 Sch 2 para 3(2).

With some careful planning, it may well be possible to thread the needle. However, in practice it is hard to see that the hassle of trying to fit within both regimes would justify the tax benefits in most cases, although someone with more imagination than these authors may be able to come up with a scenario where it did. One also suspects that HMRC would view such attempts with suspicion. However, the very fact that both regimes seemingly could apply to the same company but with slightly different tax results goes to show the slightly odd (although perhaps understandable given the evolution of the legislation) position we now find ourselves in – although those advising on more traditional securitisations may view this as the lesser evil compared to an alternative scenario involving a full overhaul of the UKSV regime. ■

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- 20 questions on QAHCs (J Burton, N Lawton & S Reilly, 5.5.22)
- Asset holding company regime: the ownership condition (R Kinghall Were & D Crossley, 24.7.22)
- UK taxation of securitisation companies (G Montagu & D Logizidis, 17.5.21)