WILLKIE FARR & GALLAGHER (UK) LLP

CLIENT ALERT

UK QAHC Update: New HMRC Guidance – When Are Credit Funds Investing?

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The UK's new qualifying asset holding company ("**QAHC**") regime, which became available from 1 April 2022, provides an opportunity for investment funds to utilise a tax efficient investment holding structure in the UK not previously available. Although this is a welcome development for the funds industry, we have previously highlighted that some questions remain. One of these was how the requirement that a QAHC be carrying on investment activity (and not trading) applies in the context of credit funds; new HM Revenue and Customs ("**HMRC**") guidance published on 6 June now provides some insights on this point.

Background

The QAHC regime provides qualifying companies with a range of tax benefits designed to provide a tax efficient structure for investment holding vehicles. Our previous client alerts which detail each of the qualifying criteria and tax benefits may be found here and here.

One of the key qualifying criteria to enter the QAHC regime is the "activity condition". This requires that the activity of an asset holding company ("**AHC**") must be the carrying on of an investment business, with any other activities being ancillary to that investment business and not carried on to any substantial extent. So far, so straightforward (for private equity funds at least).

However, the question of whether an AHC meets this condition is potentially complicated in the case of credit funds, in respect of whose activities there has long been some uncertainty over their trading versus investment nature. For some credit funds this may be a relatively simple issue; nonetheless, and as was highlighted to HMRC and HM Treasury throughout the consultation process leading up to the introduction of the regime, any uncertainty which exists in respect of a brand new regime, and one which carries potentially significant tax consequences if things go wrong, will be detrimental to its take-up.

New Guidance

In light of the above, Willkie has been engaging with HMRC to address this issue through its QAHC working group. This has resulted in updated guidance in which HMRC give some examples illustrating how they expect to approach the issue.

1. **Example 1**: The first, and perhaps simplest, example is where an AHC acquires assets (including debt instruments) which it intends to hold for the medium to long term, and in respect of which there is not a high turnover or number of transactions. In HMRC's view, this is "likely" to constitute investment activity.

   Helpfully, the guidance goes on to state that the analysis should not be affected where assets were acquired with the intention of holding as an investment, but are in fact disposed of sooner than expected because of "external events (such as changes in the market)" or the manager responds opportunistically to offers received for the assets. In such cases, the guidance indicates that the AHC should retain evidence of its initial intention and any changes in that intention (e.g. in offering memoranda and board minutes).

2. **Example 2**: In the inverse of example 1, the guidance indicates that where an AHC only acquires assets which it intends to hold in the short term, and in respect of which there is a high turnover and number of transactions over the life of the AHC, this is "likely" to constitute a trading activity – irrespective of the nature of the assets held and particularly where the AHC has operations otherwise characteristic of trading. Again, this example is much as we would expect.

3. **Example 3**: It is not uncommon for a fund, through an AHC, to seek to acquire certain assets which it can only do by purchasing a larger portfolio of assets. The fund may be content to keep the non-target assets in the portfolio, or alternatively seek to dispose of those immediately after acquisition (perhaps because they do not fit within its investment strategy) while retaining the target assets in line with its medium to long term investment strategy.

   Helpfully, the guidance indicates that this type of activity would "typically" constitute investment, "provided there is evidence of [the] intention to retain the target asset for [the] medium to long term and that this is borne out by what the AHC actually does".

   However, care should be taken where the non-target assets constitute a "substantial" proportion of the portfolio acquired, in which case there is a "greater likelihood" that the activity will be considered trading by HMRC, particularly where the AHC has dual objectives of unbundling assets to sell some at a profit and retain others in line with a longer-term investment strategy. Again the key will be to clearly record the intention on acquiring and disposing of portfolio assets.

4. **Example 4**: Loan origination has been perhaps one of the thorniest issues for credit funds in the "trading versus investing" question. In the context of the QAHC regime, the guidance states that the origination of a debt investment by an AHC, rather than acquiring debt on the secondary market, is not, by itself, an indication that the AHC is trading.

   Where an AHC originates loans and holds (or intends to hold) a significant portion of them for the medium to long term in accordance with its investment strategy, the guidance indicates that the origination activity will "likely" constitute part of the overall investment activity, meaning associated fees (e.g. participation, origination or execution fees) would be investment income.

   However, where an AHC arranges loans for others to hold (e.g. as a lead lender in a syndicated deal) and receives fees for that activity, that is likely to constitute trading activity. As a result, this trading activity must be ancillary to the investment activity and not carried on to a substantial extent in order for the AHC to meet the activity. The guidance states that the quantum of any syndication fees received compared to other investment returns is likely to be indicative of both whether the syndication activity is ancillary to the investment business and substantial. This will be a question of fact in each case, though we would expect that the condition should be met in this regard for most credit funds which originate debt in order to hold their portion of the loans for the medium to long term, and syndicate as a matter of administrative convenience in setting up the loan rather than with a view to generating significant fee income from this activity.

5. **Example 5**: The final example concerns an AHC with a strategy of investing in distressed debt. Such AHCs (and/or the credit funds behind them) are likely to more actively manage their loan book than AHCs investing in non-distressed debt, and see more dealings or conversions of its debt investments, which may make the trade versus investment distinction much less clear.

   Where an AHC intends to hold distressed debt for the medium to long term (for example, on the expectation that the debt will ultimately trade up to par value or otherwise make a substantial recovery), as in example 1 this is "likely" to constitute investment, even if opportunities are taken to sell down the debt or to participate in a debt restructuring as a result of investing in the debt.

   On the other hand, constantly renewing a book of distressed assets with a view to short term realisation may (as in example 2 above) amount to a trade; this would include where distressed debt is acquired in anticipation of a restructuring "with a view to disposing of the resulting asset immediately after the restructure, regardless of its value". Where the resulting asset is retained for the medium to long term, however, this is "likely" to continue to be considered investment.

> More difficulty arises with the situation where a distressed debt investor plays a leading role in a restructuring. In HMRC's view, leading a restructuring or insolvency process (where the other investors simply participate) "might amount to a trade". Whether this is the case "will depend on whether the AHC holds a significant position which gives it a better position than other creditors to lead the process". The guidance continues that the receipt of fees for carrying out such activity may indicate trading, particularly where such fees are not ancillary to the main investment activity.
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> While there may undoubtedly be some scenarios where leading a restructuring is part of a trading activity, we do not agree that this is so clearly the case as the guidance might indicate. Significant lenders will often take a significant role in a restructuring simply by virtue of having such a sizeable holding in the debt that their approval may be essential to the debtor being able to implement any restructuring and as an integral part of the management of their investment in that debt. Care should therefore be taken by AHCs and credit funds participating in such activity looking to enter the QAHC regime. We suggest that the intention behind any such participation be clearly documented in board minutes and other contemporaneous documents to support this forming part of an investment activity.

"Medium to Long Term"

As can be seen above, HMRC refer in many of the examples to an AHC holding investments for the "medium to long term". There is no definition as to what constitutes "medium to long term" and the guidance states that it is not possible to be specific, and it will be a question of fact in each case. It does, however, indicate that regular sales of assets within "months or even weeks" of acquisition may indicate that the AHC does not have an intention to hold assets for the medium to long term, while regular retention of assets for several years may, on the other hand, be considered as evidence of that intention.

In many cases, it is likely to be clear whether the AHC intends to hold debt investments for the medium to long term or not. In more borderline cases, or where the AHC intends to hold assets for the long term but acts opportunistically to take advantage of changes in the market, clear documentation of the reasons for establishment of the AHC and acquisition and disposal of assets will likely be of significant importance.

What Next?

While we could always hope for more, the guidance published this week provides some helpful commentary on how HMRC will approach the activity condition in respect of credit funds. It is evident that clear documentation will be vital in demonstrating the requisite investment intention in many scenarios (particularly where loans are not held until maturity). Credit funds should therefore begin thinking carefully about how their investment strategy is described in their marketing documents (the strategy of the AHC likely being that of the investors in it) and board minutes and other documents (e.g. internal memos and emails, structure papers) concerning the establishment of an AHC and investment transactions.

Overall, this guidance is useful in addressing one of the two significant "problem" areas of the QAHC regime. On the other, the treatment of parallel fund structures in assessing the ownership condition, we are expecting a "fix" from HMRC within the coming months. We will provide a further update as and when this is forthcoming.

Finally, as HMRC continues to update its guidance and respond to questions posed by advisers and the asset management industry, we are seeing an increasing number of funds expressing interest in utilising the QAHC regime. We would be very happy to discuss the regime with you if you have any questions or would like to discuss its applicability to your funds.

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