Keeping up with Alternative Investment Funds

September 2019

pwc

Introduction

Welcome to our September edition of Keeping up with Alternative Investment Funds.

As we return after our summer break, there has been no shortage of changes in the political, regulatory and legislative arena for us to pick up on, but front and centre for many will no doubt be the UK's approaching Brexit deadline in under two months.

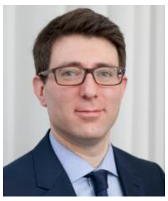
After a relatively quiet start to the summer period, the EU elections and Boris Johnson's appointment as Prime Minister has brought Brexit back on the risk radar and the questions from the financial services industry are starting to ramp up once more. As they look to the future landscape, Alternative Investment funds are asking how they can prioritise and where to begin. While there is no obvious pathway ahead on Brexit, and all options look at the very least improbable and it is still unclear as to whether we will leave on 31 October or there will be another deferral.

Given the wider political position, there are clear signs that Alternative Investment Funds need to carefully consider their own contingency planning as regulatory equivalence for our industry is not a given in a no-deal scenario. At the end of July, the European Commission published a communication document on the equivalence regime for financial services and, most significantly, for the first time revoked previously granted certain FS equivalences from five jurisdictions (Argentina, Australia, Brazil, Canada and Singapore). This is a concerning development with many UK managers hoping to rely on MiFID II equivalence provisions post-Brexit, this signal that the EU are serious about continuously monitoring, and even removing, third country equivalence.

Meanwhile, there are plenty of other things to be doing and updating you on. As such, this September edition focuses on the following topics:

- Investment Firms Directive – remuneration implications – with the investment firms regulation and directive currently being finalised in European parliament, we focus in this article on the remuneration implications resulting from the new directive.
- LIBOR impact and transition – we explore in further detail the impact of the new alternative benchmarks proposed to replace the LIBOR rates at the end of 2021 and the impact of the transition period.
- Corporate capital loss restriction for corporation tax – focusing on the extension of the corporate income loss restriction rules introduced in April 2017, the capital loss restriction rules are due to come into effect in April 2020. Here we take a look at the HMRC comments from a recent consultation, of which PwC were one of the respondents.
- Non-resident capital gains tax – an update – following our article in the June edition of Keeping up with Alternative Investment Funds in relation to the new UK non-resident capital gains tax rules, this article highlights the uncertainties are still being debated in the industry.
- Upper tribunal decision on corporate residence – a recent overturned decision at upper tribunal with respect to identifying the place of Central Management and Control is examined in further detail
- EU MDR – Hallmark D1 – a look into the EU MDR Hallmark D1 relating to common reporting standard ("CRS")

We hope that you find this edition helpful and, we look forward to bringing you more informative updates and insights in the future. Your usual PwC contact, or one of our colleagues listed on the contacts page, will be more than happy to discuss the finer details of any topics that grab your attention.



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Investment Firms Directive – remuneration implications

Background

The Investment Firms Regulation, and Directive ('IFR') & ('IFD') are currently being finalised by the European Parliament. Final publication is expected within weeks. The remuneration requirements will apply to all MiFID firms who satisfy at least one of the thresholds set out in Article 12 of IFR. These include assets under management of at least €1.2bn, annual revenues in excess of €30m, and client money held in excess of €0. This will bring many Alternative Investment Fund Managers into scope. The rules are likely to come into effect for performance periods starting after Q1 2021.

Key requirements

Material Risk Taker (MRT) identification

- A new EBA regulatory technical standard ('RTS') will set out the criteria for identifying MRTs. IFD states that as a minimum, senior management, risk takers, staff engaged in control functions, employees paid at least as much as the lowest paid of the senior management or risk takers and whose professional activities have a material impact on the risk profile of the investment firm or of the assets that it manages will need to be identified. The Directive also stipulates that the identification requirements under UCITS V and AIFMD are taken into account to minimise divergence from those regimes.
- IFD suggests that it will still be possible to exclude individuals identified under the quantitative criteria, where their professional activities do not have a material impact on the risk profile of the investment firm or of the assets that it manages, however we will only know for certain and the details of this process once the RTS is published.

Proportionality

IFD contains the concept of proportionality such that requirements apply in a way that is commensurate with the size, nature and complexity of the firm. Firms which do not trigger any of the thresholds set out in Article 12 of IFR will be defined as 'small and non-interconnected' and will not be subject to any of the remuneration requirements.

The remaining firms will be divided into 'significant' and 'non-significant' firms. Non-significant firms are those with on and off balance sheet assets of less than €100m (on a consolidated basis). These firms will have to apply some of the requirements but can disapply the more onerous structural requirements for deferral and payment in instruments. National regulators can increase the balance sheet threshold to €300m if they wish. The FCA have not yet indicated whether they will use this flexibility.

Proportionality can also be applied at individual level (the 'de minimis') where MRTs earn less than €50k variable pay and less than 25% of their total compensation is variable.

Remuneration structure requirements

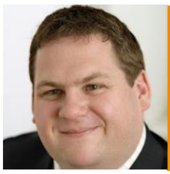
There is no formal requirement for a bonus cap. Firms are expected to set their own ratio and justify why it is appropriate which provides welcome flexibility for firms. The following requirements will need to be implemented by significant firms only:

- 40% deferral over 3-5 years, 60% where variable pay is 'particularly high'. We expect the 5 year requirement to apply to senior management as per the current CRD IV requirements. It is also likely that the FCA will continue to define an especially high amount as over £500k.
- 50% of variable pay must be paid in instruments subject to a suitable retention period. It remains to be seen whether the FCA will specify a retention period of 1 year (as per CRD) or 6 months (as per AIFMD and UCITS) however we expect that the latter is more likely.
- Instruments can include: real shares, funds or non-cash instruments which reflect either shares or funds.
- Whereas the UK banking rules currently go further than the European rules requiring 7 year deferral for senior managers and 5 year deferral for 'risk managers' our current understanding is the FCA is not currently considering introducing an equivalent provision under the extension of the senior manager regime

Next steps for Alternative Investment Funds

- Assess whether or not IFR/IFD will apply to your firm based on the regulatory permissions held.
- If IFR/IFD will apply determine if proportionality can be applied at firm or individual level.
- If IFD will apply, conduct a gap analysis of the requirements against your current remuneration arrangements to assess the level of impact on your organisation.
- Review your MRT populations to ensure the correct population have currently been identified in light of the more stringent approach to proportionality.

Contacts



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LIBOR impact and transition planning

Summary

Since 1986, the London Inter-Bank Offered Rate (LIBOR) benchmark has been used.

There are a number of reasons why LIBOR became a problem: the numerous LIBOR scandals, the interbank market dwindled, it became a proxy for the risk-free rate plus a measure of risk because it priced derivative markets far beyond the Euromarkets it was intended for, and banks don’t lend to each other as much as they used to on an unsecured basis.

Alternative benchmarks have been proposed by regulators and industry bodies to replace LIBOR rates that are anticipated to no longer be published or supported past the end of 2021. Transition to new products can and is likely to happen from now until this date, depending on the emergence of alternative products.

This transition to alternative benchmarks will have a significant commercial and operational impacts for firms, including challenges around pricing, funding, risk management, contract management and many other areas.

The transition to these new rates will require significant efforts by asset managers to address the impacts on business activities, investor interactions, control processes, systems, risk management and financial performance.

Impact on managers

Debt and derivative contracts held by the UK manager will be amended. The replacement of contracts could lead to a derecognition for accounting purposes which gives rise to UK tax charge. This can be mitigated through Interest restriction calculations on worldwide debt will require reassessment

Impact on investors

Investors will want to understand what the manager is doing to manage transition risk for them. Investor outreach and engagement will assist you to proactively manage existing investors.

Share classes might need to be reorganised or restructured as a result of LIBOR transition. Investors could be subject to capital gains where they are moved from one share class to a new one as a result of LIBOR transition but this can be mitigated by ensuring that reorganisations are structured to fall within rollover relief provisions.

Impact on the corporate entity

The investment manager needs to consider the ‘top down’ view across all funds and mandates and have an overall transition strategy. In the UK, many firms are designating responsibility for transition to a senior executive in anticipation of SM&CR. It is also important to consider the potential impact on regulatory capital given the operational risk associated with LIBOR transition.

In the UK, all regulated managers (MiFID, UCITS and AIFMs) are required to manage their LIBOR transition programme aligned to the FCA guidance in their 2019 Dear CEO letter.

Impact on transactions

Industry solutions for derivatives are emerging primarily through ISDA. However, that is not the case in respect of bonds, loans and other financial instruments are more challenging and need to be assessed now. Transaction teams will need to consider the implications for existing funding arrangements across portfolio companies. This should be considered for new investments as well as for any exit strategies. Existing funds will also need to consider the investment holding structures and financing arrangements between the various legal entities.

Impact on portfolio company and end investment

The management team of the portfolio companies are similar to the investors who will expect sufficient information on exposures, key risks and controls in order to manage their own transition risks (and maximise value for the fund and investors).

Next steps for Alternative Investment Funds

- Alternative Investment Funds should consider LIBOR transition at an early stage and the impact this could have on operations and potentially consider a LIBOR transition project.
- Alternative Investment Funds could also participate in official sector and industry consultations and acting upon any conclusions reached.

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Corporate capital loss restriction for corporation tax

Overview

The HMRC consultation on the restriction of capital losses for corporate entities has recently concluded and HMRC have published a summary of comments in response to points raised by respondents, PwC were one of the respondents to this consultation.

The capital loss restriction is an extension of the corporate income loss restriction that was introduced in April 2017 and is due to come into effect on 1 April 2020. From this date a company with chargeable gains will potentially no longer be able to utilise any unused capital losses brought forward in full. The current £5m limit in respect of the corporate income loss restriction rules ('the Deduction Allowance') will be shared with the capital gain loss restriction. Any capital losses to be utilised over and above this £5m limit in a given accounting period will be restricted to 50%.

Specific Points Addressed by HMRC

During the consultation process queries were raised in respect of the special rules for Basic Life Assurance and General Annuity Business ('BLAGAB'), particularly regarding shareholders share of BLAGAB gains and losses which most insurers do not actually calculate. HMRC have confirmed that the intention of the restriction is not to affect individuals and as such the updated legislation aims to ensure that there will be no restriction of BLAGAB losses against BLAGAB gains.

HMRC have also stated that they will provide an update on how these rules will affect companies in distress and those which are insolvent although no time frame has been given for providing such an update.

A number of concerns were raised by respondents that the rules adversely impact certain sectors which should have specific exemptions, such as medical research companies which often accumulate substantial losses prior to making substantial profits; HMRC have indicated that they will not propose any specific exemptions apart from those that have already been laid out in respect of the oil and gas sector.

Due to the existing restrictions on disposals to connected parties a number of respondents to the consultation suggested that an additional restriction would be excessive, HMRC agreed with this and have amended the legislation to allow companies to use carried forward connected party losses in place of capital losses for a given accounting period where this is applicable in a given accounting period.

Real Estate Investment Trusts ('REITs') are subject to a tax regime whereby they are typically exempt from tax on their chargeable gains and as such these new capital loss restriction rules will not be applicable for capital losses that are associated with Property Income Distributions ('PIDs').

In instances where a company has a one day accounting period, by virtue of making a disposal that is subject to capital gains tax but where the company is not otherwise chargeable to Corporation Tax, then the full amount of the £5m allowance will be available. It was highlighted that the original legislation would indicate that 1/365 of the £5m allowance would be available; HMRC have confirmed that such companies with a one day accounting period will be able to access the full £5m deductions allowance per financial year. HMRC have also indicated that they will introduce rules that will allow companies with multiple one day accounting periods in a financial year to offset capital losses against capital losses which arise in that year.

Where capital assets which are used as a hedge are disposed of, if this disposal does not take place at the same time as the asset which it is hedging, there is a potential that such gains or losses may occur in different accounting periods and may accordingly be impacted by these rules. HMRC have noted in their responses to the consultation that they will not include a specific provision to mitigate the impact of these capital loss restriction rules in such a situation.

Next steps for Alternative investment Funds

- The responses to the consultation, and the amended legislation, provide welcome clarification on a number of points, particularly in specific situations such as where a one day accounting period occurs.
- Alternative Investment Funds with significant carried forward capital losses will need to be aware of the implications of these rules and their interaction with the corporate income loss restriction rules. In particular the implications of exiting hedged positions should be assessed in the context of these rules.

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Non-resident capital gains tax – An update

Following our article in the June edition of Keeping up with Alternative Investment Funds in relation to the new UK non-resident capital gains tax rules ('UK NRCGT') and their impact on non-resident Collective Investment Vehicles ('CIVs'), this article provides several updates and clarifications received to date and highlights the uncertainties still being debated in the industry.

With effect from 6 April 2019, non-UK CIVs investing in UK Real Estate Investment Trusts ('REITs') are caught by the changes to NRCGT rules. Broadly, these rules are designed to tax non-resident investors that indirectly invest in UK land through a corporate vehicle and mean that even the disposal of shares in UK REITs will be treated as an indirect disposal of UK land and needs to be taxed and reported to HMRC.

As a result, non-UK CIVs will now need to register for corporation tax where a sale of UK property or land happens in the accounting year. The CIV will have three months to notify HMRC from the date it became chargeable to UK Corporation Tax, and these CIVs come within the charge to corporation tax on the date they make their first disposal, give or transfer any interest in UK land or property. Any holding, however small, will be caught by these rules. Double Tax Treaty ('DTT') relief may be available to a CIV in some cases, depending on whether the DTT gives taxing rights to the jurisdiction in which the CIV is tax resident and whether the CIV can access the DTT.

So far, Canadian and US funds are relatively comfortable in most cases that they can access the treaty – which gives taxing rights to Canada and the US respectively. This means that most Canadian and US funds will not be caught by these new rules and therefore no UK tax should arise. Luxembourg funds cannot access the UK-Luxembourg DTT and therefore disposals of UK REITs will bring these funds within the scope of the new rules. There is still uncertainty across the industry on the treatment of Irish funds and whether these can access the UK-Ireland DTT.

Since the guidance was released, there have been some clarifications by HMRC. Amongst other things, HMRC has clarified that a CIV need only to register for taxation if it makes a chargeable disposal. Tthere is no need to register if the disposal is an excluded disposal, an exemption applies, or where no chargeable gain or allowable loss arises. It has been clarified that notifying HMRC can be done through the application for a unique taxpayer reference ('UTR'). Applying for a UTR will need to be done at a sub-fund level so each sub-fund is treated as a separate legal entity for the purpose of the UK NRCGT rules. HMRC have also clarified that a CIV can file an iXBRL tagged annual return and there is no requirement to have a one day accounting period.

HMRC published draft regulations on 17 September which are subject to consultation and if enacted, amongst other things could expand the scope of exemptions available for companies wholly owned by qualified institutional investors to CIVs with a similar investor base and, should address a number of inadvertent practical implications arising from the current law, such as enabling the payment of tax by CIVs on behalf of investors.

Next steps for Alternative investment Funds

- Determine whether your non-resident CIVs invest in UK REITs.
- Review transaction data to identify sales of UK REITs since 6 April 2019 to determine the start of the accounting period.
- Review the relevant DTT to identify whether the UK has taxing rights.
- Determine whether the CIV is eligible to access the DTT and consider applying for clearance.
- Determine investor base and monitor availability of exemptions on enactment of Regulations.

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Upper tribunal decision on corporate residence

Background

Examination by HMRC of the place of Central Management and Control ('CMC') to test corporate residence has risen to prominence over the last two years. Identifying the place of CMC is an area where close examination of the evidence is needed to establish the facts, so these enquiries can be very burdensome. The renewed focus on this by HMRC may be attributable to HMRC's success at the First Tier Tribunal ('FTT') in the Development Securities case in July 2017.

The FTT conducted a very thorough examination of the facts in that case, including board briefing papers and board meeting minutes of the Jersey companies but concluded that it was uncommercial for the Jersey directors of newly incorporated Jersey companies to buy assets from their UK parent company at overvalue. As a consequence, and because the acquisitions were viewed by the FTT as uncommercial, the FTT held that the transaction had to be contrary to the interests of the Jersey companies. Thus, CMC of the Jersey companies was determined to be in the UK.

Following an appeal to the Upper Tribunal ('UT') by the companies, the UT has recently entirely overturned the FTT decision, finding that although the FTT had carried out a thorough examination of the facts, their decision was 'plainly wrong as a matter of law'. The FTT found as fact that there were 5 separate board meetings of the Jersey companies, where the Jersey directors properly considered the information put to them and specifically turned their minds to their fiduciary and legal obligations. The UT said that the fact that the FTT regarded this as an uncommercial transaction 'says quite literally nothing' about the FTT finding that the Jersey directors had abdicated their fiduciary duties. The UT found that the primary consideration of the Jersey directors was to act in the interests of the company shareholders. The acquisition of the assets was funded by the parent, so overpaying did not leave the Jersey companies economically disadvantaged and so it wasn't an uncommercial act. The directors acted in accordance with their duties, gave detailed consideration to the scheme, concluded it was in the best interests of the shareholder and therefore was in the best interests of the Jersey companies.

More importantly, the UT judgement provides very helpful judicial guidance of wider application for Alternative Investment Fund managers interested in understanding any risk to CMC of entities, whether in a proactive sense or indeed because of HMRC enquiry activity. This UT case highlights the following key points for any CMC examination, and for which evidence must be maintained:

- Board meetings to take place in the location of intended residence, with attendees joining in person;
- the Board meetings being the forum where directors exert paramount authority over the business and affairs of the company;
- influencing those who exercise management and control is not the same as exercising management and control; and
- proper judgement – 'bring mind to bear' – must be applied to matters under consideration and when decisions are made.

It is worth noting that, unlike the FTT, the UT judgement establishes legal precedent and this judgement sets out the important considerations when examining the test of CMC.

It should also be borne in mind that the UT decision could be appealed, although the cross appeals brought by HMRC were roundly dismissed by the UT so it is not clear what the point of law is that could serve as grounds of appeal.

Next steps for Alternative Investment Funds

- Alternative Investment Funds may find it useful to conduct a proactive corporate residence review in order to pre-empt any potential issue occurring in the future.
- CMC is found at the highest level of control over the business and affairs of the company. This is a facts based test, and so having appropriate evidence of that is crucial.

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EU MDR – Hallmark D1 requires a different approach

The draft UK regulations to implement EU Directive 2018/822 ('DAC6') were published in July. A full summary of the various hallmarks that trigger reporting obligations under these rules and the impact of the regimes for Alternative Fund mangers can be found here.

Many of the hallmarks are only triggered if one of the main benefits of the arrangement is to obtain a tax advantage. Hallmark D1 related to the Common Reporting Standard ('CRS') is not the same, and so Alternative Fund managers will need to give particular attention to the application of this hallmark.

Hallmark D1 requires information reporting on arrangements that have the effect of circumventing the CRS information reporting regime. A 'CRS Avoidance Arrangement' is any arrangement for which it is reasonable to conclude that it is designed to circumvent, is marketed as, or has the effect of circumventing CRS Legislation or exploiting an absence thereof. This is a subjective standard that looks at whether entity classification, documentation, due diligence and reporting have the effect of undermining the objectives of CRS. The preamble to DAC6 and UK Regulation 12(c) sensibly point to the Mandatory Disclosure Rules ('MDR') developed by the OECD and related commentary as a source of interpretation. The OECD has more material available in relation to Hallmark D1 than any other, including detailed commentary and a specific schema for reporting.

CRS stands alone in being unable to leverage other UK compliance regimes such as the Anti Tax Avoidance Directive ('ATAD'), Disclosure of Tax Avoidance Schemes ('DOTAS'), Senior Accounting Officer ('SAO'), General Anti-Avoidance Rule ('GAAR') and Country-by-Country Reporting ('CBCR') to identify reportable transactions as these regimes do not apply to financial account reporting by third parties. The notable exception is the Corporate Criminal Offence for the Facilitation of Tax Evasion ('CCO') – which does leverage certain CRS procedures, but requires criminal evasion by a taxpayer and this may not be relevant when, for instance, a protector of a trust escapes reporting under the CRS. Moreover, the CRS is a relatively new compliance regime and contains notable and deliberate ambiguities such as the definition of a 'Controlling Person' or a 'Customer', which involve subjective determinations in the absence of clear guidance.

Where might decisions taken in the CRS compliance project implicate Hallmark D1?

Example 1

CRS Entity Classification: A trustee classifies a trust as an active Non-Financial Entity ('NFE') based on the gross income test when it is structured to earn no income during the testing period. Zero passive income divided by zero gross income is mathematically undefined and a reasonable person may determine that classifying the entity as an active NFE and not disclosing Controlling Persons undermines the CRS. This could be reportable by an intermediary under the MDR using schema code MDR804.

Questions to consider: *Have records been maintained of financial accounts so that updated CRS self-certifications can be provided? What should be done in terms of retroactive/amended reporting by financial institutions;*

Example 2

CRS client due diligence: A financial institution onboards a client that has presented a document based on a citizenship by investment scheme (identified by the OECD as abusive) and does not apply the 'reason to know rules' to conduct a further enquiry. This specifically has been identified as a situation that undermines the CRS and should be reportable under Schema code MDR601 – Tax residence.

Questions to consider: *Would a remediation program be required to capture the data required to prove reporting was not required? If reporting is required, should historical returns be amended?*

Next steps for Alternative investment Funds

- Review and update CRS risk register/frameworks (there is not a complete overlap with CCO controls).
- Review onboarding process steps, in particular the application of the reason to know principles in light of OECD and market understanding of avoidance schemes.
- Refresh entity classification decisions to determine that assumptions are reasonable and that the application of the rules results in a valid classification.
- Leverage the OECD's MDR Schema for CRS avoidance arrangements and define data models to support DAC6 reporting.

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