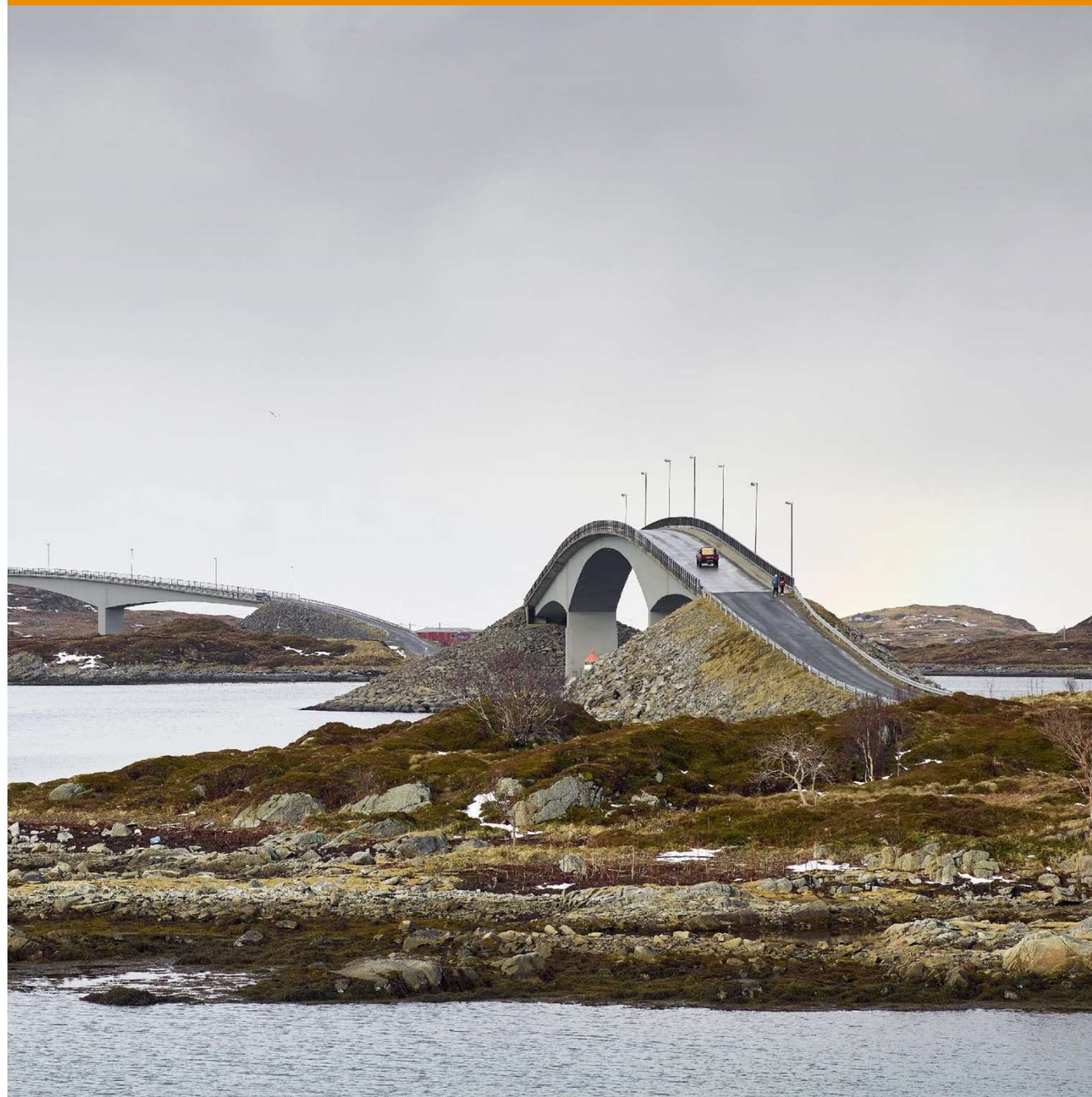
Keeping up with Alternative Investment Funds

October 2019



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Introduction

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

As uncertainty regarding Brexit continues, the UK's political landscape is going through a historic time, testing the constitutional balances of the executive, the judiciary and the legislative powers.

With a further extension to Brexit now agreed with EU leaders until 31 January 2020 and a December General Election, it is vital that Alternative Investment Funds keep abreast of developments and are able stay agile in the face of an ever-changing environment.

If you need a refresh of all our Beyond Brexit and tax materials, please take a look at our Brexit Hub on the PwC Suite here. You can also find Keeping up with Brexit for Asset and Wealth Managers ("AWM") on the Suite here, focusing on a range of political, tax and regulatory considerations for AWMs looking to mitigate the risks of Brexit and the continued uncertainty.

Away from Brexit, we had hoped that HMRC would have released their long-anticipated guidance accompanying the Income Based Carried Interest ("IBCI") legislation this month, however we continue to await the publication of this and hope to update you shortly.

Meanwhile, there are plenty of other matters to update you on and this October edition focuses on the following topics:

- HMRC enquiries on Disguised Investment Management Fees ("DIMF") and carried interest – here we take a look at the DIMF rules, highlighting some recent HMRC enquiries and the steps that should be taken by Alternative Investment Funds to help ensure they are prepared in the event of an enquiry.
- EU MDR - Time for action – we provide an update on the key issues effecting Alternative Investment Funds and outline actions that should be taken by tax functions following the release of draft regulations in July.
- How can you manage the risks arising from the changing tax transparency landscape? – this covers some recent developments in the tax transparency landscape and what are the key things to focus on in developing a response to these changes.
- Business Risk Review – the new approach from 1 October 2019 – we explore the key changes and potential impacts following the launch of the new Business Risk Review ("BRR") process on 1 October.
- Dutch 2019 budget day - Tax package – we provide an overview of the proposed measures further to the Dutch government presenting their 2020 Dutch tax package on 2019 budget day.

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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HMRC enquiries on DIMF and carried interest

Summary

The introduction of the Disguised Investment Management Fees (“DIMF”) rules and new carried interest rules in 2015 represented a significant change for the Alternative Investment Fund management industry as the UK government made a significant shift in approach with regards to how investment management professionals are taxed in the UK.

What are the rules?

Broadly, the DIMF rules work to treat any sums from investment funds arising to an individual providing investment management services as trading income for UK tax purposes (with some exceptions for qualifying carried interest and co-investment arrangements) regardless of the underlying nature of that return.

Subsequent changes

There have been several rounds of changes to the rules since their introduction, which have broadened some of the definitions within the legislation and added additional complexity when interpreting the rules.

Current focus

We are now beginning to see carried interest, and other amounts paid to investment managers, coming under increasing scrutiny from HMRC and becoming the subject of personal tax enquiries.

Typically, enquiries are being targeted at groups of executives in the same investment management house (i.e. in only rare cases an enquiry will be targeted at one individual). Notwithstanding this, only in very rare cases are all enquiries into executives from the same house initially being raised by the same inspector. These often become more co-ordinated as the responses progress.

At present, as these types of enquiries are only starting to be seen, there is limited detail available on the technical basis of HMRC's interpretation of particular aspects of the DIMF and carried interest legislation.

Instead, HMRC appear at this stage to be asking individuals and their advisors to provide the technical analysis as to why a relevant tax charge does not apply i.e. why a certain filing position has been taken.

Managing a DIMF enquiry

Where personal enquiries are raised into several members of the same “House”, there are advantages in the House being actively involved in the responses, and in some cases actually co-ordinating elements of the responses to some of the questions raised by HMRC.

In our experience this helps clarify for the individuals the particular aspects of the fund structure which HMRC may be targeting. In addition, the House may find that it is preferable to provide one co-ordinated response and answer a number of the queries centrally, rather than piecemeal by way of a number of separate responses. This helps to provide some consistency in the responses made to HMRC.

Next steps for Alternative investment Funds

- Ensure you are prepared with relevant information that might be required in the event of an enquiry and have documented the technical approach adopted.
- Consider whether it would make sense to co-ordinate enquiries for executives at the House level.
- Consult with your PwC tax advisor with regards to approach.

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EU MDR - Time for action

Background

When the EU adopted its Mandatory Disclosure Regime in May 2018, the first reporting deadline of August 2020 seemed a long time off. Now it is fast approaching and looks very real. As each country introduces its legislation ahead of 31 December 2019, there is a flurry of questions from Alternative Investment Funds on how to best manage implementation.

The basics

The Mandatory Disclosure Regime ("EU MDR" or "DAC 6") requires disclosure to tax authorities of cross border arrangements that meet certain hallmarks. The disclosure of arrangements implemented from 25 June 2018 is required by the end of August 2020. Disclosure of arrangements post 1 July 2020 are required within 30 days of a trigger point.

How have Alternative Investment Funds responded to date?

Most have waited for local legislation before taking action. Following the UK draft regulations in July 2019 and the consultation closing, most Alternative Investment Funds are stating they intend to have an approach implemented by Spring 2020.

What are the key technical issues for Alternative Investment Funds?

Reporting obligations fall on all intermediaries, unless another has already reported. An intermediary is defined, broadly, as anyone who helps design, promote, or implement a reportable cross border arrangement. Many Alternative Investment Funds will therefore be intermediaries in their own right.

Many Alternative Investment Funds have a high volume of complex transactions across multiple asset classes and territories. Each also have different advisors considering their own reporting requirements. Most Alternative Investment Funds have lean tax functions, so this creates a risk and compliance burden to be managed. There are a number of specific technical issues for Alternative Investment Funds. These include:

1. Deal structuring relating to the acquisition, restructuring, and disposal of investments. These are likely to be supported by intermediaries. Managing the number of disclosures, costs, and management time can be challenging.
2. Subsequent arrangements such as refinancing, restructuring, bolt on acquisitions, or part disposals. External advice is not always sought, or may happen without Tax input. A robust governance framework is key here.
3. House fund structuring. This is typically done with support from advisors, meaning that reporting is usually managed and less of a concern.
4. Partner and investor taxes are an area of concern as these are often arrangements with no intermediary or Tax input.
5. Portfolio companies. Tax should determine the level of oversight of arrangements at portfolio level. This should take into account tax audit risks and exit price chips.

Doubt remains over how hallmarks apply to particular transactions. This includes uncertainty on whether Fund subscriptions and ISDA documents fall within the definition of standard documentation, or whether transfers of shares are caught by the transfer pricing profit shifting hallmark. Identifying the relevant arrangement to be analysed is important, as looking at the components of a transaction, rather than the whole, may result in an incorrect assessment.

The proposed UK implementation also throws up differences. For example, the UK looks at non EU tax savings in assessing the tax benefit, whereas the directive only covers EU taxes. The definition of tax residence proposed in the UK draft regulations is also unclear, since it would lead to disclosure of tax deductible payments made to the US LLCs or Cayman holding companies commonly used by US investors. The UK's proposed extended definition of "tax advantage", relevant to the hallmarks that are subject to the main benefit test, may be helpful to reduce the level of disclosures to HMRC.

What practical approaches are Alternative Investment Funds taking?

A challenge arises in bringing internal teams and multiple external intermediaries to the same technical view and establishing accurate, timely reporting processes. Alternative Investment Funds with a clear 'house view', and internal processes aligned with advisors will be best placed.

Technical impact assessment

The technical complexity, volume of analysis and reporting, and level of perceived risk drive the level of processes and infrastructure needed.

Most Alternative Investment Funds are conducting high level impact assessments over their arrangements, the hallmarks triggered, and whether reporting is required. Areas of technical uncertainty are then flagged for review. Documenting this in an impact assessment matrix and policy paper to be shared with advisors helps ensure a clear 'house view'.

Governance framework development

This will be driven by the impact assessment results. The firm's wider approach to risk will also be important. Alternative Investment Funds are aiming to avoid 'over engineering' governance design, but want a pragmatic approach covering key roles and responsibilities, engagement scoping, and reporting.

Tools and technology for reporting

Again, this is driven by the volume and complexity of transactions, and organisational factors. There are now a wide range of tools being deployed. At a basic level, tailored spreadsheets listing reportable transactions are common for smaller firms. At a more complex level, automated solutions capture each step of the analysis process. These can be completed by internal teams or external advisors, automatically apply local rules, and allow submission to territory tax portals. These also incorporate document storage, workflow tracking, and analytics capabilities.

Next steps for Alternative investment Funds

It is clear that alternatives view this as the time for action on EU MDR. To ensure this, tax functions should now be:

- Conducting a technical analysis to assess the impact of the rules.
- Putting in place lean governance frameworks to ensure an efficient approach is taken to reporting requirements.
- Ensure the right reporting tools are selected based on the volume and complexity of transactions.

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How can you manage the risks arising from the changing tax transparency landscape?

Insights from benchmarking tax

The tax landscape is changing and is increasingly no longer just a private matter for a tax function, but a topic of increasing interest to a range of stakeholders including the media, NGOs, analysts, tax authorities, employees, and customers. This scrutiny brings risk for the tax department and managing that risk is a renewed area of focus for many investment managers' tax teams. Understanding how you compare to your peers and the comparative view that a stakeholder would form of your tax affairs can help to assess and manage that risk.

Some recent developments in the tax transparency landscape

Tax strategy: all large companies should now have published their approach to tax, ensuring that, in line with the latest guidance from HMRC, the strategy states the relevant paragraph of the legislation and a date within the last twelve months to show that the statement is current. But does anyone read tax strategy statements? An academic paper used data analytics to review tax strategies published by US headquartered companies operating in the UK. It highlighted instances where a company, due to its size, should have published a strategy and didn't. It also identified those strategies with very similar 'boiler plate' wording, indicating, according to the authors, poor engagement with the purpose of the legislation. The use of data analytics in reviewing tax disclosures is likely to increase.

Publication of country-by-country ('CbC') data: all large companies should now have also disclosed their CbC data privately to tax authorities. There is a push for this data to be publicly available and the GRI (an organisation devoted to sustainability) has issued a consultation for a new standard on 'Tax and payments to governments' with a focus on public CbC reporting. Internal communication with teams responsible for sustainability reporting is essential.

Release of tax principles: a group of large multinational corporations, branded as 'The B Team' has come together, working with NGOs, investors and tax authorities, to prepare a set of seven principles to guide companies as they develop tax disclosures. Companies have endorsed, engaged with and expressed interest in this company led initiative. It is a vital way for views of companies themselves to be discussed.

Investor attention on tax is increasing: Norges Bank Investment Management recently released a paper setting out their expectations for management in relation to tax. In another sector, RobecoSAM uses effective tax rates as a guide to 'indicate overly aggressive tax optimization, which may represent a potential source of risk for a company'. In this context, a coherent explanation of your tax affairs is essential. Understanding how your effective tax rate compares to the average for your sector and the reasons for any differences can help to inform your disclosures.

How is the market responding to these changes?

The tax transparency debate is evolving and some leading companies are helping to shape that debate. When developing an approach to tax transparency, it is important to consider whether additional disclosures would create value and who the disclosures are intended for.

Key to developing a response to the tax transparency landscape is to understand how you compare to your peers and the comparative view that a stakeholder would form of your tax affairs.

- How does your effective tax rate and cash tax rate compare to the average for your sector (or selected peers) and what are the reasons for any differences? While the focus on effective tax rates has reduced in recent years, a comparison of your effective tax rate compared to a named small peer group can provide high level messages for a non-tax expert in the business.

- How do your tax disclosures compare to your peers? If discussing the risks and benefits of tax disclosures internally, benchmarking against peers in the areas of tax strategy, tax governance, tax numbers and performance and the wider impact of tax can be insightful.

Next steps for Alternative investment Funds

- Stay ahead of the debate by understanding current developments in tax transparency and how they apply to your specific arrangements, ensuring that key internal stakeholders are briefed. Use public data benchmarking to gain insights into the approach to tax adopted by your portfolio companies and investments.
- ETR benchmarking: use our data visualisation tool based on publicly available data to understand how your effective tax rate compares to a global and sector peer group.
- Tax disclosure benchmarking: understand how your tax disclosures compare to your peers based on our most recent review of 2018 annual reports.

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Business Risk Review – the new approach from 1 October 2019

Following HMRC's pilot of the new Business Risk Review ("BRR") process HMRC have now finalised the low risk indicators that will be used and released a FAQs sheet confirming go live from 1 October 2019. Any BRR after this date will follow the new process. There have only been limited changes to the low risk indicators since the pilot with the low risk indicator wording adjusting only slightly. The Tax Compliance Risk Management manual which is the externally available guidance on the BRR process will be updated shortly ready for the launch on 1 October.

What are the key changes?

Tax payers will be assessed against low risk indicators under 3 headings - Internal Governance, Approach to Tax Compliance and Systems and Delivery.

There is a move away from the binary low risk / non - low risk ratings to a broader rating scale of low, moderate, moderate - high and high risk with specific ratings for individual taxes (e.g. Corporation Tax, Indirect Taxes and Employment Taxes).

Explicit consideration will be given to compliance with other tax governance requirements such as Senior Accounting Officer ("SAO"), UK Corporate Criminal Offence rules in respect of the criminal facilitation of tax evasion ("CCO"), Tax Strategy, Country by Country reporting ("CbCR") as well as where appropriate the Banking Code of Practice on Taxation for Banks ("The Code").

HMRC will increasingly seek to assess if taxpayers have sufficient resources (people, systems, processes) in place to deliver all tax obligations - both within the tax function and wider business functions which impact on tax processes.

There are also increased expectations in respect of documented risk and control registers, tax policies and procedures being in place, available to share with HMRC, and subject to assurance checks and testing.

What are the potential impacts?

The new process represents a raised level of expectation from HMRC, resulting in additional challenges for those managing the organisation's tax affairs. It will determine the nature, extent and tone of interactions with HMRC over the next review cycle and is likely to attract greater internal scrutiny from senior stakeholders in the organisation such as the SAO and the Audit Committee.

Next steps for Alternative investment Funds

It is important to start planning now either in anticipation of your next BRR or in assessing the extent to which the BRR process is applicable for you. Key steps include:

- Ensuring you understand the new requirements, the extent to which they are relevant for your business, and where HMRC would rate your current approach to tax governance, compliance and risk management on their risk profile spectrum.
- Undertaking an assessment to identify any areas that require updating or enhancement with appropriate remediation activities identified and actioned.
- Being able to articulate to HMRC the positive behavioural attributes of your organisation's approach to managing tax resulting in you enjoying the benefits of being considered low risk over time.

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Dutch 2019 budget day – Tax package

The Dutch government, on September 17 2019 (Dutch budget day), presented the Dutch tax package. The proposed measures include a reduced corporate income tax rate, along with a conditional withholding tax on outgoing interest and royalty payments to affiliated entities in low-tax jurisdictions, which will enter into force on January 1 2021. The package also contains amendments to the existing anti-abuse provisions in the Corporate Income Tax Act and Dividend Withholding Tax Act as a result of the Court of Justice of the European Union (CJEU)'s Danish beneficial ownership cases. These amendments are proposed to enter into force on January 1, 2020.

Top corporate income tax rate adjustment

Under the 2020 tax package, the top corporate income tax rate (currently 25%) will be reduced to 21.7% as per January 1 2021.

The tax rate for profits up to and including EUR 200,000 (currently 19%) will be reduced to 16.5% as per January 1 2020 and 15% as per January 1 2021.

Conditional withholding tax on interest and royalty payments to tax havens

A conditional withholding tax (WHT) on certain outgoing interest and royalty payments will be at a 21.7% rate. These rules only apply to interest and royalty payments made or accrued to affiliated companies (i.e., those over which decisive control is exercised) in low-tax jurisdictions (i.e., jurisdictions with a corporate tax rate below 9%, or jurisdictions included in the EU's non-cooperative jurisdictions blacklist).Targeted anti-abuse rules will apply to certain structures involving branches, hybrid entities, or interposed entities.

The conditional WHT on interest and royalty payments does not provide an exception for situations where the payments become non-deductible (such as due to anti-hybrid rules). Consequently, the anti-abuse rules could result in double taxation in certain cases.

Observation: Counter evidence rules remain available in certain scenarios whereby an entity has been interposed and it should be reviewed to determine whether they can be relied upon.

Anti-abuse provisions in corporate income tax and dividend WHT

Following the CJEU's Danish beneficial ownership cases, members of the Dutch parliament raised questions with the Dutch State Secretary of Finance on interpreting the CJEU's decisions and its impact on the Dutch tax rules to prevent 'abusive' structures.

Under the current rules, 'minimum substance requirements' work as a 'safe harbour' provision by treating intermediate entities meeting relevant substance conditions as non-abusive from a Dutch tax perspective. This safe harbour can be applied only if there is a company with a material business enterprise (including employees) in the direct line on top of the Dutch company that holds (indirectly) a 100% interest in the Dutch company.

As a result of the decisions in the Danish beneficial ownership cases, the Dutch government proposed amendments to the existing anti-abuse provisions in the Corporate Income Tax Act (particularly the CFC rules, the foreign taxpayer rules, and the rules for Dutch Financial Service Companies) and the Dividend Withholding Tax Act (particularly the objective test in the domestic withholding tax exemption) that are considered to be 'safe harbour' rules.

The proposed amendments allow the Dutch tax authorities to substantiate a structure's 'abusive' nature regardless of whether relevant specific substance requirements are met. Similarly, Dutch corporate income taxpayers will be provided with the opportunity to advocate for a non-abusive structure, even when they do not meet all of the aforementioned Dutch substance requirements.

Dutch corporate income tax liquidation loss rule limitation

While the Dutch government wants to curtail the deduction for foreign losses, it must consider the frameworks of EU and European Economic Area (EEA) law. As such, if a deductible liquidation loss exceeds EUR 5 million, the liquidation loss provision would apply only in EU/EEA situations in case the interests give rise to decisive influence on the participation's activities (i.e. more than 50%). The proposed entry into force is January 1, 2021, with a three-year transitional period for unrealized liquidation losses incurred before January 1, 2021. This proposal is not part of the 2020 tax package and most likely will not be debated in Parliament until next year.

Adjustment to innovation box tax rate

The Dutch government is expected to increase the innovation box regime's reduced effective tax rate to 9% as of January 1, 2021. Under the current innovation box, the taxpayer may opt to apply a reduced effective tax rate of 7% on taxable profits derived from qualifying income related to intangible assets.

Amendment to the permanent establishment definition for Dutch corporate income tax and personal income tax purposes

The government proposes to adjust the permanent establishment definition for inbound investments and non-treaty scenarios, which should align with the definition from the most recent OECD developments reflecting BEPS action item 7 and the MLI provisions.

Next steps for Alternative investment Funds

- The reduced Dutch corporate income tax rate might create a tax benefit for you going forward, to the extent Dutch corporate vehicles are used in your structures.
- Where relevant, determine whether you meet the new standards of the amended anti-abuse rules included in the Dutch Corporate Income Tax Act and Dividend Withholding Tax Act as of January 1, 2020.
- Review interests and royalties paid by Dutch entities to affiliated entities to determine whether these payments would fall under the scope of the newly proposed conditional withholding tax on interest and royalty payments as of January 1, 2021.

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