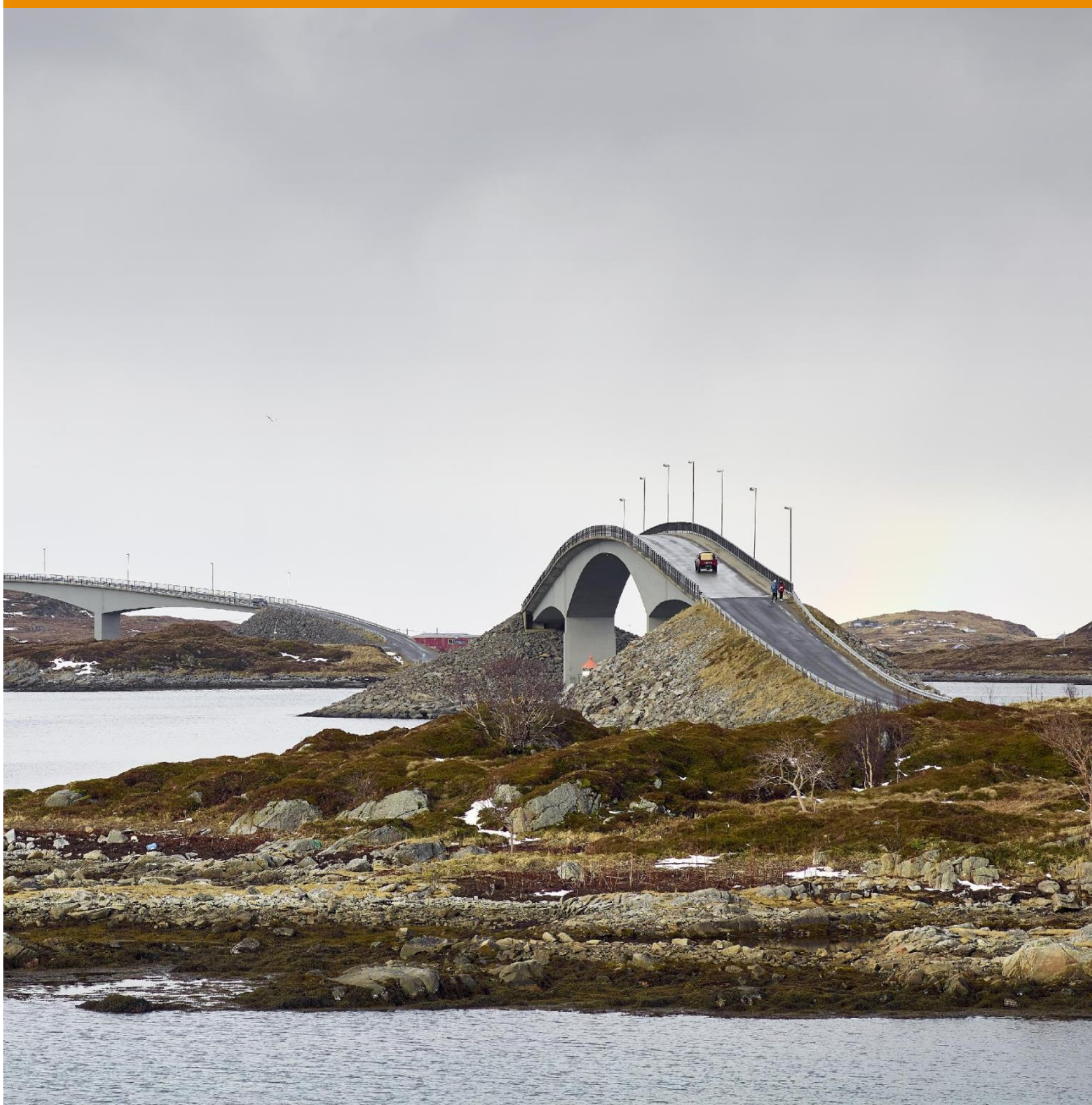
Keeping up with Alternative Investment Funds

November 2019



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Introduction

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

We were delighted to hold two Alternative Investment Fund Network Breakfast Roundtable on 29th and 30th October, one for our Private Capital and Real Asset clients, hosted by Marc Susgaard-Vigon, and one for our Liquid Asset clients, hosted by Moonir Kazi. The topics of discussion covered at both events included:

The transition of LIBOR – We discussed LIBOR reform, especially how this will impact Private Equity and Credit Funds. We have taken the opportunity to address the main "talking points" in this edition.

An update on EU MDR – We discussed the roll out of the EU Mandatory Disclosure Regime ("DAC 6"), in particular:

Draft UK legislation has been circulated but with the upcoming General Election, the final regulations are now unlikely to be seen this year. The UK draft rules differ significantly from the Directive in respect of the "tax main benefit test" which also takes into account non-EU taxes but only applies where the tax advantage is contrary to the policies or principals of the legislation. In short, the UK main benefit test will only capture tax avoidance. Whilst that sounds helpful, disclosures may still be needed elsewhere in Europe under local EUMDR rules for the same arrangement.

Across Europe legislation is slipping into place and that is producing increased activity and awareness. The first filings at the end of next Summer are starting to look quite close. We explained at the Roundtable that Alternative Investment Fund managers should expect to start receiving questions from intermediaries and we recommended the attendees to start developing plans for managing EUMDR compliance.

Rewards and remuneration in particular looking at the effects on Alternative Investment Fund managers – Here we discussed how new digital capabilities are changing the way HMRC test the application of the employment related securities rules to the awards of co-investment and carried interest. The attendees had not necessarily seen much evidence in this space, but we understand that HMRC are now using existing data more effectively to test employer compliance.

OECD Digitalisation of the Economy – The proposed unified approach on Pillar I and the latest intel from OCED on Pillar II were the key points from this topic. The work at the OECD is moving at pace and we expect more developments in the coming months particularly around Pillar I. We will await to see whether there will be a financial services exemption but in any event the changes around the transfer pricing models particularly around marketing / distribution models could have impact for most Alternative Investment Managers. Similarly, the Pillar II work on the development of the minimum tax, and particularly for Continental European countries, represents the basis by which they can collect additional tax. We expect that most of this work will be done by about Q3, 2020.

PwC Alternative Investment Funds Conference 2020

We will be holding the Alternative Investment Funds Conference on Tuesday 25 February 2020 from 1.30pm at our More London office.

This conference will focus on a broad spectrum of issues arising to asset managers who provide alternative investment products to their clients ranging across private equity, private credit, liquid assets / hedge funds and real asset investing.

Topics we will be covering include 21st Century Fund Structuring, 21st Century Management Company Structures and Issues, OECD latest proposals around Transfer Pricing and HMRC Activity & Operational Resilience.

The conference will feature presentations and panel discussions from a mixture of speakers. In addition, you will get a chance to interact with PwC's technology, data, consulting and cyber security teams over coffee and drinks.

We very much hope that you will be able to join us at the event and if you have any questions please get in touch with your usual PwC contact.

Latest Developments

As the uncertainty around Brexit continues the current hot topic in the UK is the General Election due to take place on 12 December 2019. With some party manifestos discussing an increase in taxes and others an effective abolishment in some taxes we await the final result and expect to update you on this in next month's edition.

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

- Non-resident capital gains tax update – here we provide an update on the new UK non-resident capital gains tax rules ('UK NRCGT') and their impact on non-resident Collective Investment Vehicles ('CIVs'), as well as some responses from HMRC to some of the queries raised by the Investment Association ('IA').
- LIBOR reform – impact on the tax affairs of Alternative Investment Funds – we provide an overview of the LIBOR reform in 2022 and potential consequences.
- IR35 – 4 months to go! – we cover an overview of IR35 and with only a few months to go until the new regime takes effect, we identify some of the practical challenges to consider prior to April.
- HMRC's focus on investors in Offshore Funds – we provide a brief overview of offshore funds and the reporting fund status regime.
- Smooth moves – using capital allowances and business rates to your advantage on an office move project – here we cover an overview of how you can maximising the UK tax relief available through the capital allowances regime. We have also include a step plan to help navigate through this area.

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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Non-resident capital gains tax update

Context

Following previous editions of Keeping up with Alternative Investment Funds on the new UK non-resident capital gains tax rules ('UK NRCGT') and their impact on non-resident Collective Investment Vehicles ('CIVs'), there have been further updates and clarifications.

Update

As noted in September, HMRC issued draft regulations which were open for consultation until the 25th October 2019. Notable amendments made by the proposed regulations include:

- CIVs which make a transparency election to be treated as partnerships will need to disclose information in relation to their investors, and they will also have an obligation to submit partnership returns.
- Tax exempt investors that indirectly invest in UK property rich vehicles (other than REITs) can continue to benefit from exemption when they invest through holding structures such as CCFs/JPUTs/FCPs. This is subject to the holding structures being wholly (or almost wholly) owned by tax exempt investors.

Market representations

The Investment Association ('IA') submitted their response to the consultation requesting:

- The NRCGT rules to allow REITs to make the relevant transparency/exemption elections to bring them on the same footing as PAIFs and other UK property rich entities.
- Allow tax transparent funds (such as Irish CCFs, French FCPs, JPUTs) investing in REITs to make the relevant elections under the NRCGT rules. These entities typically cannot access DTT as they are transparent for tax purposes, and unless they are UK property rich, they cannot make the relevant elections. This means that they will suffer the tax burden which will be passed on to their investors under the NRCGT rules, even where the investors could have benefited from treaty relief had they invested in the assets directly.

HMRC response

HMRC recently responded to some of the queries raised by the IA which should help provide more clarity.

- Sub-funds of offshore umbrella funds will be treated in the same way as UK sub-funds for the purposes of the application of the instalment payment regulations, and therefore will not be deemed to be 'associated companies' for Quarterly Instalment Payment ('QIP') purposes.
- There should be no penalty for registering a CIV for UK CT purposes prior to the first disposal of a UK property rich vehicle. However, in doing so, the offshore CIV accounting period structure may have been set up incorrectly on HMRC systems. The offshore CIV may receive a notice to file a return for a period during which a disposal has not been made. In such cases, providing that the return filing date had not yet been reached, the offshore CIV may alter the accounting period to the correct one via Online Services. Please do speak to us if you think this issue is relevant in your case.
- Despite HMRC guidance stating that a 12 month accounting period for an offshore CIV will only apply if there are more than 4 disposals in a year, all offshore CIVs are currently being treated as having a 12 month accounting period. If however, a particular offshore CIV will have 3 or fewer disposals in a financial year, they may have a one-day AP for each disposal if this is preferable. The CIV will have to notify HMRC of the relevant accounting period structure.
- If the accounts are not prepared under UK GAAP, US GAAP or IFRS, non-resident may submit PDFs of their accounts (i.e. no iXBRL tagging required). Otherwise they are subject to the same filing requirements as UK resident companies.

Next steps for alternative investment funds

- Ensure you review your full product ranges and assess whether there are any property investments likely to bring them in the scope of the new rules.
- You should then review your investor base to determine which if any exemptions/reliefs are available to them.
- Registration, filing and tax payment deadlines will depend upon the specific facts in each case and may not be aligned product by product, as such you should consider your filing and reporting obligations under the rules for any disposals made on or after 6 April 2019.
- HMRC have provided clarity on a number of points that were raised, however there are still unanswered questions and inadvertent practical implications which require further commentary. Developments in the legislation, regulations, guidance and ongoing dialogue with HMRC should be closely monitored.

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LIBOR reform – impact on the tax affairs of alternative investment funds

LIBOR, the London Interbank Offered Rate, which was famously described as 'the world's most important number', is set for retirement by 2022. After a series of scandals culminating in the LIBOR rigging scandal in 2012 and subsequent public oversight of the figure, the FSA has called time on LIBOR, and the contributing financial institutions will no longer be required to provide the requisite data. LIBOR's shoes, with £300 trillion of assets linked to LIBOR worldwide, or five times global GDP, will be difficult to fill.

Since the announcement by the Bank of England in 2017, a raft of new measures have been floated to replace LIBOR, but consensus has fallen on SONIA ('Sterling Overnight Interbank Average rate'), as the preferred sterling replacement. USD rates are expected to be tied to SOFR ('Secured Overnight Financing Rate'), Euro rates to EONIA ('Euro Overnight Index Average') and CHF to the SARON ('the Swiss Average Rate Overnight').

Changes underway

Large financial institutions (predominantly banks) have started to adapt their floating rate contracts to adapt to the new environment, typically combining LIBOR with its replacement index rate in its contracts. However, with £300 trillion worth of underpinning contracts to re-write worldwide, the process is painful, and the consequences not well understood.

Meanwhile, the IASB is still consulting with stakeholders how best to tackle the difficulties the change throws up. The IASB comment window on the Phase I exposure draft closes on 17 June 2019, but there are myriad areas which the IASB will have to consider as part of its Phase II project on LIBOR reforms as well.

Business implications

Changes to the reference rate could have a substantial accounting impact across all businesses. Cash instruments and derivatives currently tied to LIBOR will require modification. However, if that modification is deemed to be 'substantial', then the existing asset/liability will be derecognised from the balance sheet and replaced with the fair value equivalent, whilst any gain or loss would go to the P&L.

Similarly, a change in hedge documentation normally requires that the hedge relationship is discontinued; this may give rise to hedge ineffectiveness in a cash flow hedge. Further, previously effective hedge arrangements may no longer meet the criteria under IAS39 to be deemed effective if the market valuation of the hedging instrument moves ahead of the change in the underlying asset (or vice versa). Whether there is an accelerated or delayed response to the LIBOR change in the market will impact whether hedges remain effective, any failed hedges will again be taken to the P&L.

Consequences for Tax

While the principle impact of LIBOR reform will fall on the accountants and lawyers, changes could have significant knock-on tax consequences. The de facto 'deemed disposal' of cash instruments and derivatives may trigger any unrealised gains to be recycled through the P&L and subject to tax.

Second, changes in loan relationship income from intra-group loans are likely to change the arithmetic on Groups' CIR calculations. The proposed rates are roughly equivalent, but with large amounts of variable rate debt, even a small shift could be significant. The carry forward provisions of excess interest expense should capture any additional volatility, but messaging that is crucial.

Third, any change to the underlying value of business as a result of changes in the discount rate may impact DTA recoverability. Broadly, we expect that the new measures will be more volatile, and so DTA recognition may fluctuate year-to-year. Together with crystalised tax charges, this is likely to impact Solvency II, albeit on a lesser basis than the first tier impact of implementation.

Next steps for Alternative Investment Funds

- It continues to be important that Alternative Investment Funds establish a LIBOR transition project and thoroughly assess their and their clients' exposure to LIBOR.
- Once the scope of the change has been quantified, it is also important to understand how the changes are likely to be handled from an accounting perspective. If contracts are valued on a LIBOR replacement rate, the fair value of those contracts may change ahead of any actual changes to contracts.

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IR35 – 4 months to go!

The forthcoming off payroll working in the private sector legislation represents one of the most significant changes to the taxation of the contingent workforce for 20 years.

With only a few months to go until the new regime takes effect, this article looks at some of the practical challenges asset managers will need to consider prior to April.

Background

Currently, where a private sector enterprise engages with its contingent workforce via personal service companies (PSCs) or other intermediaries, it is (normally) insulated from any obligation to assess the status of the worker and to apply PAYE/NIC. Instead this obligation sits with the worker (via his/her PSC).

From 6 April 2020, this responsibility will be transferred such that medium or large sized asset managers will be responsible for assessing the employment status of the worker and any resultant PAYE, NIC and Apprenticeship Levy obligation will need to be met by the "fee payer" (which could be the asset manager "client" or a third party such as an MSP or agency).

1. Cost - All things being equal, a contingent worker, who is regarded under IR35 as a "disguised employee" will attract a 14.3%, above the line cost, in the form of employer's NIC and Apprenticeship Levy. For businesses in the sector with partial exempt status for VAT purposes, this problem is compounded as IR35 doesn't change the VAT status of the worker and, therefore, they may continue to suffer blocked input VAT as well as an increased NIC bill. Furthermore, certain "critical" workers may demand "make whole" payments to compensate them for what they contend is a loss in take home pay;

2. Operational risk - Many contingent workers may be engaged on business critical projects. Many of these contractors may be concerned with both the immediate tax hit of a disguised employment assessment under IR35 as well as the optics of the engager taking a view that is contrary to their previous "self assessment" in earlier years. In this regard, whilst a recent HMRC guidance note indicates that HMRC would "only use information resulting from these changes to open a new enquiry into earlier years if there is reason to suspect fraud or criminal behaviour", this is unlikely to fully alleviate contractor concerns given the statement's lack of statutory force and absence of an explicit prohibition of data being used in "open" or "routine" enquiries. Consequently, there is a risk that contractors may seek to move for optical or cost reasons even if a new role is subject to PAYE which may in turn have an impact on project delivery;

3. Tax risk - In the UK, there is no statutory definition of employment. Instead, organisations and workers alike must look to a series of tests devised by the courts and paint a picture of whether the worker is, in reality, an employee based on the facts of each engagement. Such an assessment naturally requires a degree of judgment which is capable of being challenged by the worker, through a "client led" statutory appeals process, and HMRC.

The draft legislation includes a "reasonable care" test whilst HMRC have also stated they will stand behind the results of their CEST assessment tool "provided the information input is accurate and the tool is used in accordance with [their] guidance".

IR35 may thus be thought of as a balancing act for Alternative Investment Funds, ensuring their compliance systems and/or operating model is designed to eliminate tax risk whilst simultaneously taking measures to reduce cost where appropriate and mitigate against operational risk.

Understanding the current state

We would regard a current state assessment as being a critical precursor to any IR35 planning exercise. Such an exercise enables businesses to forecast the potential impact on their cost base, identify data or control deficiencies and any business critical resources potentially "at risk" under IR35.

Common problems at this stage include; identifying PSCs who meet the gateway tests for IR35 (but may be hidden amongst other vendors in the General Ledger or embedded in larger consultancy contracts), assessing for "disguised employment" status and modelling for the impact of different decisions.

A desired end state

It is important that key stakeholders in any organisation have a shared vision of the desired end state for IR35 reform. This vision will be informed by agreement over key design principles and an understanding of the current state but must also be tempered by pragmatism given the short time remaining to be compliant.

Key questions informing this strategy include:

- What appetite is there for change within the organisation;
- Is there scope for wholesale/selective changes to operating/procurement models to reduce administration and/or cost or does the organisation simply want to create a process to ensure it can remain compliant under the new law;
- Should a strategy be built to address an organisation's direct responsibilities or should a more holistic approach be taken to managing risk in the supply chain; and
- Does the organisation understand the labour market dynamics of its impacted workforce? What tolerance does the organisation have to workforce churn.

IR35 – 4 months to go!

Executing the plan

Once there is this shared vision, an implementation plan can be developed, refined and put into action. Here too, there will be critical decisions and milestones. The details of this will depend on the aforementioned vision but may include, for example;

- The design of the assessment process and choice of platform;
- The development of a communications strategy and appeals process;
- The implementation and testing of appropriate compliance systems; and
- Overall governance (including addressing any non-compliant models which may be marketed to the business).

Conclusion

IR35 represents a sizeable challenge for asset managers given the traditionally high use of contingent workers.

Responsibility for managing the issue will cut across a number of functions and competencies but tax and finance will have a key role at each stage of the process from understanding the current state, through to developing and executing on the strategy.

Given the expansive nature of the issue and limited time remaining before the new rules take effect, we are recommending that all organisations ensure that they do not leave it too late to adequately plan for and deliver a compliant IR35 strategy.

Next steps for Alternative Investment Funds

- Ensure that they have identified the contractors and supply chains potentially caught by IR35 and form a view of the worker's criticality and tenure.
- Undertake an assessment to determine which workers and roles are likely to be regarded as "disguised employees" under IR35.
- Undertake cost forecasting of different options and pay policies.
- Assess options and develop a project plan to implement the chosen strategy.

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HMRC's focus on investors in Offshore Funds

Background

In advance of the personal tax return filing deadline on 31 January 2020, HMRC have started issuing "nudge letters" to high net worth individuals and those dealt with by HMRC's wealthy and mid-sized business unit who may hold interests in Offshore Funds. These letters are designed to educate investors so they can comply with their tax filing obligations.

The letters issued by HMRC give details of the differing tax treatment of the amounts realised from investments in Offshore Funds, which varies depending on whether the funds are regarded as 'approved' by HMRC (i.e. funds with UK Reporting Fund Status). Due to the complexity of these rules, HMRC suggests that mistakes can be made in this area when completing tax returns.

Taxation of Offshore Funds

Broadly, HMRC define an Offshore Fund as an investment vehicle resident in a territory outside of the UK. The status of the Offshore Fund will determine how HMRC taxes income arising from these investments, and individuals must ensure they declare the appropriate amounts on their tax return.

Some fund managers, predominantly in the alternative fund management sector, have for a variety of reasons adopted the position that their offshore vehicles do not fall within the offshore fund rules, either because they do not meet the definition of a 'mutual fund' or because they can rely on the Unlisted Trading Company Exception (applicable to many Private Equity and private credit funds). As a result these vehicles have not obtained Reporting Fund Status.

However, many Offshore Mutual Funds would fall under offshore fund rules and where an Offshore Fund has obtained Reporting Fund Status ('RFS'), individuals must declare the amount of any cash distributions received during the tax period alongside the Excess Reportable Income ('ERI'), which is broadly the amount of taxable income which remains in the Fund each period following distributions. ERI is deemed to arise 6 months after the end of the Offshore Fund's period of account and care should be taken to ensure ERI is included in the individual's tax return for the relevant tax year. For example, where an Offshore Fund's year-end falls on 31 December 2019, any ERI is deemed to arise on 30 June 2020 thus falling in the tax year 20/21 rather than tax year 19/20.

As the ERI is deemed income, which is not physically paid, it is often missed by individuals as it is generally not included in end of tax year reports that are provided. As such, the onus often falls on the individual to determine if any ERI should be reported on their tax returns.

HMRC Correspondence

The nudge letters tell the individual that it is their responsibility to tell HMRC about their UK tax liabilities from offshore income and gains anywhere in the world, and that it is important that taxpayers check that they have declared all their UK tax liabilities.
The letters generally give 30 days to respond and all of them include a "Certificate of Tax Position" form which HMRC ask the individual to complete and return whether they have additional tax liabilities to disclose or not.
On the certificate, the individual is asked to sign and make a declaration to the effect that:

1.The information they provide on the certificate is "correct and complete to the best of their knowledge and belief" ; and
2.They understand that choosing to make a false statement or complete a false certificate is a criminal offence that can result in investigation and prosecution.

Recipients are also asked to tick that either:

1.Their tax affairs need to be brought up to date and they will make a disclosure of irregularities through the Worldwide Disclosure Facility ('WDF'); or
2.Their tax affairs do not need updating and they do not have additional tax to pay.

There is then a further declaration: "I have declared all of my offshore income, assets and gains which are taxable in the UK".

What you should do if you receive one of these letters from HMRC?

- The first point to note is that HMRC is saying in the letter that they are aware that you have overseas income, not that your tax return is necessarily wrong. Also there is no legal obligation on you to complete the 'Certificate of tax position' and return it to HMRC. However, it is essential to check whether your tax affairs are correct and complete to the best of your knowledge and belief before responding to the letter.
- If no disclosure is needed, you may want to consider sending HMRC an explanation by letter. Where no response is received, HMRC may follow up so not responding at all could attract more attention from HMRC. Responding to the initial letter may reduce the risks of further action being taken by HMRC.
- If a disclosure is required, the letter advises that this must be made via the WDF but using the WDF may not necessarily be the most appropriate method. Depending on your individual circumstances, other approaches may be better.

Next steps for Alternative Investment Funds

- It is important those fund vehicles relying on exemptions from the Offshore Funds rules to review that analysis to ensure it remains valid and we recommend that you speak to your advisor if you are unsure.
- If you are in receipt of one of these letters and you would like advice on how to proceed, please contact your usual PwC contact or one of the contacts listed below.
- Individuals with investments in Offshore Funds should review their tax affairs to that any ERI has been correctly reported on their annual tax returns. The correct tax treatment upon disposal or receipt of distributions from Offshore Funds can also be complex and should also be reviewed.

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Smooth moves – using capital allowances and business rates to your advantage on an office move project

Background

With record levels of new UK office space currently in construction and being pre-let, many businesses are currently in the midst of, or are gearing up for, an office move project in the short term. Our Alternative Investment Fund clients are no exception, with many upgrading their UK property portfolio to meet the demands of a modern workforce. Such one-off projects present unique challenges to internal tax and finance teams, particularly in the area of capital allowances and business rates where there has been recent legislative change.

Where an office move project is being planned, there are opportunities to optimise the UK tax position through:

a) Maximising the UK tax relief available through the capital allowances regime; and
b) Reducing the liability of business rates by utilising the available statutory reliefs and appraising the underlying property valuation.

We have set out a "step plan" below to help you navigate the benefits and difficulties of the rules.

Step 1 - Exit from current premises and lease (incl. dilapidations and sub-leases)

On exiting a current premises, it is important to consider how the decisions taken from legal, commercial and property perspectives will inform the required tax analysis. If the correct steps are not undertaken or the relevant information is not documented, the available tax relief can be reduced or even foregone.

Of course, a multitude of scenarios can take place on exit from an existing premises, each with their own tax complexities but the key point is that significant tax relief through capital allowances or revenue deductions may be available in respect of dilapidations payments/works on the exit of a lease. A reduction in business rates may be available if an existing office is left vacant until the end of the lease term.

Step 2 - Agreement of lease for new premises (tenant incentives)

On agreement of a new lease over a premises, tenant incentives offered by the landlord can include rent-free periods, cash inducements or capital contributions toward the tenant fit out works. While the first two options have their specific direct tax consequences, where capital contributions are received toward tenant works, the tax outcome will largely be driven by the commercial and legal position negotiated.

Step 3 - Fit-out of new premises

Given the capital expenditure typically involved in the primary fit-out works, the tax relief available through claiming capital allowances is material and is normally reviewed by a specialist capital allowances adviser to:

a) Optimise the quantum of capital allowances available; and
b) Identify all enhanced and accelerated tax reliefs (including Enhanced Capital Allowances, Research and Development Allowances, Structures and Buildings Allowances, Short Life Assets)

Given the quantum of tax relief at stake, HMRC expect to receive a detailed capital allowances analysis to support any claim for capital allowances within the tenant's relevant UK tax computations. Protecting your risk position with HMRC through appropriate analysis and disclosure in respect of the fit-out works is a critical element of the project, especially in light of the current UK tax environment.

It is also important to remember that in many circumstances business rates should not be paid during the tenant fit-out period at the full rate. A review of the business rates calculation for the periods affected by the fit-out works should be reviewed in detail to ensure the available reliefs are applied correctly.

Step 4 - Ongoing costs and maintenance of new premises

Once the new office is fully operational, we typically see businesses repair, reconfigure or expand the premises in the short to medium term. This presents another opportunity to maximise tax relief on the expenditure incurred either through capital allowances, structures and buildings allowances or revenue deductions. For tax purposes, a large percentage of such expenditure is typically revenue in nature and so the accounting classification becomes important in accelerating the available tax relief. Consideration of this point should be dealt with prior to the relevant financial statements being finalised and audited.

As referred to in Step 1, there may also be an opportunity to make a specific accounting provision for dilapidation works during the life of the lease, leading to an acceleration of the associated tax relief. Such planning should be considered in light of the specific facts of the required dilapidation works.

From a business rates perspective, it is important to ensure the correct rateable value is applied to the premises so that business rates paid are based on relevant and supportable data. This is particularly important where the premises are newly constructed by the landlord, given there will be no established rateable value for business rates purposes on initial occupation. Business rates costs are fixed for a number of years based on this valuation, as such it is important this analysis is undertaken thoroughly from the outset.

Next steps for Alternative investment Funds

- If you are in the early stages of an office move or are contemplating a move in the near future, seek capital allowances and business rates tax advice as early as possible. Your ability to optimise the tax position can diminish once legal agreements are entered into and the opportunities to plan ahead for the resulting tax analysis are closed off.
- If you are toward the completion phase of an office move or have already in place at your new office, there are still opportunities to generate UK tax relief.
- Optimising the capital allowances and business rates analysis concurrently is an efficient and beneficial approach to such projects.

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