Keeping up with Tax – Asset and Wealth Management

March 2020

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Welcome…

Welcome to our March edition of Keeping up with Tax – Asset and Wealth Management. The news cycle in February was somewhat dominated by the Covid-19 outbreak, commonly referred to as coronavirus. While the focus is inevitably, and rightly, on the significant human cost of the outbreak, asset and wealth managers ('AWMs') will undoubtedly be considering the potential impact on their business too as the uncertainty continues. Many have already reacted, with the most commonly implemented measures being travel restrictions of varying degrees, and we know that all businesses will be continuously monitoring the situation for some time to come. While all AWMs will be impacted differently, our Global Crisis team has put together a helpful webpage to help businesses understand how they can mitigate the impact and look after their people as the situation develops. In the immediate term, many AWMs will have upcoming financial reporting deadlines for which they rely on teams in affected areas, and it is worth thinking now about whether this could have a knock-on impact on other reporting and compliance obligations further down the line.

The crisis has brought into sharp focus just how globally connected our people, systems and businesses are, and it's more important than ever that AWMs are ready to face disruption to the sector and to the economy as seamlessly as possible. Continuing our series on how you can both cope with and harness the power of disruptive technology in the financial services sector, in February we released the latest report in our **Currency of Collision** campaign. You can download our report on why financial services is distinct from other industries in this regard, and our asset and wealth management specific report provides some more targeted guidance.

On the political front, while the end of January brought a certain amount of much sought-after certainty with the UK formally leaving the European Union, February brought an unexpected cabinet reshuffle which led, perhaps most significantly, to the resignation of Chancellor Sajid Javid. Whether this will have a significant impact remains to be seen, but we got our first real glimpse of the economic policy of the new government in the Budget on 11 March. We will include more detailed insight into the announcements in next month's edition, but of great interest to AWMs will no doubt be the UK Funds Regime and the Overseas Funds Regime consultation papers released by the Government yesterday.

On to this month's edition, and on the regulatory side we've picked up on the recent industry focus on fund liquidity, including an article on the results of the FCA's 2019 consultation on illiquid assets and open-ended funds. Focusing on tax matters, we have covered two interesting recent pieces of case law, one in the VAT recovery space, and the other regarding dividend withholding tax reclaims in the Netherlands. We also discuss some specific issues AWMs should be reflecting on in the post-Brexit world, the profound impact of the OECD's plans to reach a consensus solution to the digitalisation of the economy by the end of the year, and much more. In full, we have the following articles for you to read in this month's edition:

- UK VAT recovery – Melford Capital, an alternative view
- Finland
  - Guidance published relating to withholding on dividends paid to Finnish residents via nominee structures
  - Withholding tax: Positive news for contractual funds and bad news for corporate funds
- OECD/G20 Inclusive Framework moves forward on new tax rules
- Netherlands – Small steps in the litigation path for Dutch withholding tax refunds
- UK – Illiquid assets and open-ended funds, FCA guidance come into force in September 2020
- EU – Impact of Brexit on fund products
- US – Arrival of Brexit puts treaty claims at risk
- UK – Franked investment income: why are HMRC writing to UK investment funds about their pre-2009 UK CT returns?

As always, please continue to share your feedback with us, and please feel free to get in touch with one of the contacts listed below each article, or your usual PwC contact, if you wish to discuss anything further.

Kind regards,

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UK VAT recovery – Melford Capital, an alternative view

The decision of the First Tier Tribunal ('FTT') in the case of Melford Capital General Partner Limited ('Melford Capital') appears to be one of the more surprising decisions issued by the FTT in recent years, particularly as it is directly at odds with HMRC's long established policy on input tax recovery for private equity businesses with onshore (e.g. UK based) funds.

The key issue at stake in Melford Capital was whether it was able to recover all the input VAT incurred by it or only a portion of that input VAT.

Background

The structure in question is fairly typical for a UK onshore private equity structure. Melford Capital is a member of a VAT group, along with an LLP. Melford Capital is the General Partner ('GP') of a Limited Partnership ('the Fund'), which also formed part of the VAT group by virtue of GP's inclusion in the VAT group.

Melford Capital incurred costs, some of which were in relation to setting up and operating Special Purpose Vehicles ('SPVs'). The SPVs, together with another company, Hyde Park Hayes Limited ('HRH'), were members of a separate VAT Group. The shares of HRH are held by the LP Fund, and HRH holds the shares in the SPVs.

HRH and the SPVs are provided advisory services, property management and administration services by the LLP. These supplies are subject to VAT. However, the VAT group also received repayments of interest free-loans, dividends and liquidation proceeds from the SPVs investments via the LP. Such transactions are not considered supplies for VAT purposes – these are treated as 'non-economic in VAT terminology.

To date, it has generally been accepted that a business solely involved in such non-economic activities would not normally be entitled to deduct input VAT. This principle has underpinned HMRC's policy to date, which has been to allow a degree of input VAT recovery for private equity businesses, typically based on taxable revenue streams and/or 'taxable' transactions. However, HMRC will typically require an input tax restriction in relation to the fund investment activity.

The VAT recovery position adopted by Melford Capital was to seek to recover all the input VAT incurred by it, which led to the case being brought before the FTT.

Arguments – Melford Capital

Melford Capital argued that whilst it made taxable supplies of management services and also held investments via the Fund, the VAT Group should be viewed as a single taxpayer for VAT purposes that only made taxable supplies. It argued that the VAT group's activities were equivalent to those of a holding company that conducts economic activity via the management services provided to its subsidiaries (as established in **MVM Magyar**) and despite the fact that the VAT group received two streams of revenue (e.g. taxable management services and the receipt of dividends/liquidation proceeds), the non-economic activities (e.g. the receipt of dividends/liquidation proceeds) should be disregarded from any apportionment calculation.

Arguments – HMRC

HMRC's view is that the costs incurred by Melford Capital should be analysed based on whether they are components of an economic activity. In its opinion, the Fund investments which led to the receipt of dividend income and the return of interest free loan payments from the SPVs was non-economic in nature. As such, the proper input VAT recovery analysis should (in HMRC's view) be that a portion of the VAT incurred by the VAT Group on day to day management of the business should be recoverable, whereas the VAT incurred which related solely to the set up and dissolution of the Fund should be entirely irrecoverable. The fact that Melford Capital was a member of a VAT Group that made only taxable supplies did not, in HMRC's view, lead to the conclusion that the Fund was engaged in economic activity, nor that input tax should be fully recoverable.

HMRC also contended that Melford Capital was not akin to a holding company managing investments in subsidiaries but rather simply engaged in the activity of making investments. The shares held by the Fund in HRH were with a view to receiving dividends or a return on capital on a sale. It was not correct to view the Fund as a holding company for the SPVs as it is HRH that holds the shares in the SPVs. In HMRC's view, the costs attributable to the investment activity did have a direct and immediate link to an economic or taxable activity.

FTT decision

The FTT found in favour of Melford Capital and, in principle, allowed VAT recovery in full, as the VAT Group made no exempt activities. The FTT appears to have taken a holistic view of Melford Capital's activities and considered that there was no separate investment activity that was distinct from its activities as an active holding company for HRH and the SPVs. The costs incurred in setting up the SPVs and providing finance to those entities was undertaken in order to provide advisory services to those entities. As such, the FTT found that there was a direct and immediate link between the costs incurred by Melford Capital and the economic activity carried on by the VAT Group.

UK VAT recovery – Melford Capital, an alternative view (cont'd)

We should highlight that as Melford Capital made no exempt supplies for VAT purposes, such as receiving interest payments on loan finance provided by it, the scenario whereby a business makes both taxable and exempt supplies, and is also potentially engaged in non-economic activity (as is the case with certain Private Equity businesses) was not considered by the FTT in this case. Our assumption is therefore that HMRC would still expect a restriction to be made to the VAT recovered by such businesses in such cases.

The CJEU **University of Cambridge ('UOC')** case also examined the recovery of input VAT where non-economic activities were undertaken. In this case, the CJEU found in favour of the tax authority. Whilst the background facts in **UOC** are different, the decision in Melford Capital does appear on the face of it to be at odds with **UOC**. We are aware that HMRC has welcomed the **UOC** decision and therefore it can be expected that HMRC will seek to apply that decision more broadly.

The fact that the FTT found in favour of Melford Capital does underscore the challenges faced by tax departments and finance functions in reaching decisions on what, if any, input VAT can be recovered in certain situations. Indeed, there are an ever-growing number of areas where the precise level of allowable input VAT recovery is far from certain.

Next steps for asset and wealth managers

Whilst the FTT decision is at first look somewhat surprising, we believe that it is sensible for businesses with similar fact patterns to the Melford Capital case to consider the submission of historic VAT claims to HMRC to protect their positions.

However, we do suggest that businesses approach this matter with some caution. Given the long established principles held by HMRC in this area, we consider it very likely that HMRC will appeal this decision, or at the very least, continue to challenge instances where businesses have recovered VAT in situations where there is, in HMRC's view, no direct and immediate link to exclusively economic or taxable services.

It is important for asset and wealth managers to review their activities to reconsider their entitlement to input VAT recovery, particularly where there is (or may be) income received from subsidiaries and investee companies.

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Finland – Guidance published relating to withholding on dividends paid to Finnish residents via nominee structures

Background

On 30th January 2020, Vero Skatt (the Finnish tax authority) issued an unofficial English translation of their guidance relating to the new withholding regime applicable to dividends paid from Finnish nominee-registered shares to Finnish residents.

These new Finnish resident withholding tax rules were introduced to combat perceived abuse by certain Finnish residents using nominees to hold their Finnish equities and receive a more beneficial tax treatment thus bearing similarities to the origins of the Foreign Account Tax Compliance Act ('FATCA').

The guidance summarises the new withholding regime setting out that withholding tax is applied at a rate of 25.5% on dividends paid from publicly listed companies to Finnish resident natural persons and estates of deceased persons. No such withholding is deducted from dividends paid to certain Finnish corporate entities. However, where the payor cannot obtain information on the dividend beneficiary in order to identify them, but knows the beneficiary is resident in Finland, the payor must withhold 50% from the dividend.

For those familiar with the U.S. withholding rules, the 50% unknown Finnish resident tax will evoke comparisons with U.S. **backup withholding** – a similar penalty-type tax applied to certain income and proceeds where U.S. persons fail to provide their valid taxpayer identification number and documentation to payors.

The guidance is targeted at payors of the dividends (the issuer) but can also be used by parties to which the payor may have outsourced its responsibility to identify beneficiaries. Further updates to the guidance are expected later in 2020 to accommodate the new regulations that will come into force in 2021 that address withholding on dividends paid from Finnish nominee-registered shares to non-Finnish residents (i.e. TRACE).

Other Selected Highlights

- The guidance reinforces the obligation on payors to obtain the required information about dividend beneficiaries which includes awareness of the beneficiaries' residence or non-residence of Finland.
- The guidance clarifies that payors are entitled to delegate their responsibility to obtain information on beneficiaries to the custodian nearest to the dividend beneficiary. Where this is applied, the relevant information must be passed from the custodian through the payment chain to the payor in order for the correct tax (or exemption) to be applied. Interestingly, the guidance states that the custodian can identify the facts and examine clients in the same way required for international exchange of information (i.e. FATCA/Common Reporting Standard ('CRS')/Directive on Administrative Co-operation ('DAC2') rules).
- The guidance provides helpful examples of circumstances where the 50% withholding may be applied including a scenario where a Finnish resident beneficiary refuses to provide consent to their custodian for their information to be shared with the payor for onward reporting to the Finnish tax authority.
- The guidance also provides commentary on the requirement for payors to submit tax returns electronically in accordance with their tax period and annual information reports that contain beneficiary information with special instructions on the reporting of beneficiaries that have been subject to the 50% withholding rate.

Next steps for asset and wealth managers

Custodians and investors involved in the payment chain of dividends to and from Finnish nominee-registered shares are recommended to familiarise themselves with these changes to withholding tax in Finland and the forthcoming changes expected under the TRACE model.

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Finland – Withholding tax: Positive news for contractual funds and bad news for corporate funds

Background

Under the previous tax rules a tax exemption of withholding tax ('WHT') on dividends paid by a Finnish company was available for Finnish and non-Finnish:

- Undertakings for Collective Investment in Transferable Securities ('UCITS') Funds, and
- regulated non-UCITS-funds having a contractual legal form.

There was no clear legislation or guidance on how to establish the comparability between a Finnish and a non-Finnish investment fund. The 'comparability test' has developed via tax and court practice over time and was based on a case-by-case analysis.

The new tax legislation applicable as of 1 January 2020 explicitly provides the conditions for tax exemption for Finnish and non-Finnish investment funds.

Criteria to benefit from the WHT exemption

Under the newly published guidance, the **Finnish Funds** able to benefit from the tax exemption are:

- UCITS Funds;
- non-UCITS funds (subject to being 'open' funds); or
- non-UCITS funds making mainly real estate investments.

For **EU/EEA funds,** the criteria to be tax exempt for Finnish tax purposes are:

- UCITS funds which are of a contractual form, and comparable to a Finnish UCITS fund;
- non-UCITS funds which are of a contractual form, open and comparable to a Finnish non-UCITS fund; and
- non-UCITS funds investing in real estate subject to meeting certain preconditions.

For foreign funds registered outside of EEA,

- Finland must have an agreement on exchange of tax information with the country of registration of the fund, and sufficient information for the purposes of Finnish tax process must be factually obtained from such country.
- Funds must have been established in accordance with the local legislation that is, broadly, comparable to UCITS or the Alternative Investment Fund Managers Act.

The exemption of dividends under the listed fund exemption has not been updated by the guidance and remains unchanged.

Impact on non-Finnish corporate and trust funds

Before the issuance of the guidance, certain non-Finnish corporate funds and trust funds have been regarded as comparable to a Finnish corporation (e.g. a Finnish limited liability company). For those non-Finnish funds that are corporate in nature, the exemption from Finnish WHT on dividends will not be available anymore.

Trust funds, in accordance to the guidance from Finnish Tax Administration, may qualify as corporate funds or as contractual funds depending on the facts and circumstances of each case.

For corporate funds that have been eligible for dividend WHT exemption in Finland under the listed Fund exemption, the tax exemption should remain.

However, please note that there is a case pending the Court of Justice of the EU (case C-480/19) may change the outcome for those foreign corporate funds (e.g. UCITS-SICAVs) that have not previously been eligible for the tax exemption in Finland.

Next steps for asset and wealth managers

Whilst a tax exemption will continue to be available for foreign contractual funds that are comparable to Finnish funds, the exemption will be available to a more limited number of foreign funds, as they now have to meet the legal form criteria and be contractual funds as opposed to corporate funds.

It is therefore important for foreign funds receiving Finnish source income to review its constitutional documentation in order to determine whether the tax exemption continues to be available as from FY20.

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OECD/G20 Inclusive Framework moves forward on new tax rules

In Brief

Following the conclusion of a two-day meeting at the end of January, the OECD/G20 Inclusive Framework on BEPS (the 'Inclusive Framework') issued a package of documents that update the state-of-play regarding work on tax challenges arising from the digitalisation of the economy, and set forth a revised work program. The Inclusive Framework endorsed the OECD Secretariat's concept of a 'Unified Approach' to Pillar One on profit allocation/nexus rules and committed to achieving agreement within 2020. Whether Pillar One will apply only as a safe harbour will be held for ultimate decision until the key design features have been agreed, as countries' views strongly differ on this point – although it is agreed that unilateral measures will need to be withdrawn.

In Detail

Background

The Inclusive Framework – comprised of nearly 140 jurisdictions – has been seeking a solution to the tax challenges arising from digitalisation of the economy. After preparatory work, the Inclusive Framework settled on an initial approach based on two pillars:

- Pillar One proposes a three-part profit allocation mechanism that partially departs from the arm's length principle (while also creating a new taxing right that is not based on physical presence), and
- Pillar Two would feature both an income inclusion rule (i.e. generally a foreign minimum tax) and denial of deductions for base-eroding payments, as well as other supporting rules.

These pillars form the core of the proposed new system, although many technical details remain unresolved regarding operation of the rules in practice. More details on the project (including our previous detailed bulletins) can be seen here.

The Inclusive Framework document package includes:

- a political statement;
- an outline of the Pillar One Unified Approach architecture;
- a revised work program;
- a chart illustrating Amount A effects on multinational entities (MNEs); and
- a progress note on Pillar Two.

The Political Statement

The political statement highlights that, for the first time, the Inclusive Framework is supporting the Unified Approach as the basis for further negotiations on revising taxing rights. This endorsement refocuses member countries on a mixed approach to profit allocation and nexus from the various proposals set out earlier – user participation, marketing intangibles, and significant economic presence. A key goal of Pillar One will be to increase tax certainty through effective dispute prevention and resolution features. Members must resolve several critical concepts, including whether to structure Amount A to account for differences amongst digital companies; the structure of dispute prevention/resolution tools; regional differences; and continued application of digital services taxes and other unilateral measures.

The Pillar One Approach

In the Pillar One Unified Approach outline, the Inclusive Framework states that the scope of Amount A would be focused on two types of businesses: automated digital services (generally involving online advertising and searches, cloud computing, social media and intermediation platforms, and streaming services), and consumer-facing businesses (where revenues are generated from the ultimate sale of goods and services to individual consumers). There will be specific carve-outs for most extractive industries and commodities, financial service activities that are not retail in nature, and airline/shipping activities.

The applicable threshold for in-scope businesses will consider an overall group gross revenue threshold, with additional limits based on aggregate in-scope revenues, and a de minimis threshold. Amount A nexus would not be based on physical presence but rather on significant and sustained engagement in a market jurisdiction; a revenue threshold could be the sole determiner for automated digital services, while other consumer-facing businesses will need a variety of factors. The nexus revisions will require a design to limit filing and tax-related obligations in market jurisdictions and may involve a one-stop shop concept for registration and reporting.

As Amount A will feature a formula-based allocation mechanism – looking at a portion of deemed residual profits – there are many technical issues to resolve, including the use of business line/regional segmentation, the notion of digital differentiation, and specific revenue-sourcing rules for different business models. The outline identifies profit before tax as the most favourable profit level indicator and stressed the need for loss carry forward rules to apply.

Work to determine how to avoid double counting among Amounts A, B, and C, as well as mechanisms for double taxation relief, will continue.

OECD/G20 Inclusive Framework moves forward on new tax rules (cont'd)

Regarding Amount B, the outline notes that the fixed return for baseline marketing and distribution activities is 'based on' the arm's length principle, but will need to account for regional, industry, and functionality differences. A definition of baseline activities will need to be developed but likely will include no/low risk, lack of intangibles, and routine levels of functionality. Further technical work is envisioned on profit level indicator, fixed percentage at an agreed profit, benchmarking studies, and regional/industry differentiation. The stated goal is for Amount B to operate within the existing treaty network.

The outline recognises a clear need for increased tax certainty under the Unified Approach, particularly before tax assessments are made and to make them binding in nature. In addition to enhancing traditional dispute prevention and resolution tools, a review panel is also being considered to help make determinations regarding Amount A aspects (such as scope). Subject to consensus, mandatory binding dispute resolution tools will be developed.

The exact implementation method for the Unified Approach is still being explored, although domestic legislation and tax treaty changes clearly would be necessary, along with transition rules. A multilateral convention potentially could solve a number of difficult technical implementation issues but would require the highest levels of political support.
The outline emphasises that commitment to implementing Pillar One will require countries to withdraw relevant unilateral measures.

Based on the US request, the Inclusive Framework will consider an alternative Pillar One approach involving a safe harbor whereby electing MNEs would be subject to Pillar One on a global basis. That work will occur concurrently and will focus on technical issues such as potential Amount A scope modifications, administrative rules, and avoidance of double taxation.

The Work Program

The revised Work Program for Pillar One sets out eleven work streams covering a broad range of issues that need to be addressed in refining the proposal.

Pillar Two Progress Note

The Progress Note on Pillar Two indicates that technical work is underway, although the note provides few details. Work continues on policy and design issues, such as the use of financial accounts (and dealing with temporary differences), blending options, carve-outs, and coordination between the income inclusion and undertaxed payments rules.
The minimum rate has not yet been discussed.

On the horizon

The next full Inclusive Framework meeting will take place at the beginning of July; there is an ambition that the IF will be able to sign off on a complete political agreement covering Pillars One and Two at this time, allowing the OECD to deliver a report to the G20 Leaders at their November meeting. Further work to determine the technical mechanics of the political framework will occur and implementation will require several years for countries to put in place requisite legislation and multilateral instruments. An implementation package is therefore unlikely to be ready before the end of 2021 (or later).

Next steps for asset and wealth managers

Asset and wealth managers should monitor the progress of the OECD in this area and assess potential impact when the measures become more practical and tangible to businesses.

The key takeaways are:

- The Inclusive Framework is doubling down on its ambitious timeline to come up with a consensus solution by the end of 2020; this puts significant strain on all pressure points as inability to bridge gaps among countries through additional negotiation time makes it harder to achieve consensus.
- Explicit mention of removing unilateral measures as a condition for consensus is a welcome acknowledgement, but there is lack of clarity on which measures will be affected.
- Tax certainty is key to achieving the project's goals, but there is not yet a clear view on how to achieve binding resolution.

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Netherlands – Small steps in the litigation path for Dutch withholding tax refunds

Background

On 30 January 2020, the Court of Justice of the EU ('CJEU') rendered its judgment in the Köln-Aktienfonds Deka ('Deka') case (C156/17). In this case, the Dutch Supreme Court had referred three questions to the CJEU regarding the taxation of non-Dutch investors on dividends received from Dutch companies. These questions concerned the compatibility of the Dutch Fiscal Investment Institution ('FII') regime (as it read until end of 2007) with EU law, and, more specifically, the withholding tax legislation and availability of tax exemptions applied to foreign investors.

The claimant and FII regime

Deka received dividends from Dutch shares which were subject to Dutch dividend withholding tax. Deka applied for a refund of Dutch dividend withholding tax, considering itself comparable to a Dutch FII.

Deka requested a refund on the basis that it was comparable to a Dutch FII and the Dutch tax authorities rejected the application on the grounds that Deka did not comply with all the requirements to qualify as FII.

Meeting the FII requirements

In the CJEU's view, EU Member States are free to define material and formal requirements which must be met to benefit from a local tax regime. However, these requirements should apply indiscriminately, and the burden of proof should not make it impossible or excessively difficult for a non-resident to obtain the tax advantage.

Shareholder requirements

Deka argued that it was difficult to prove that it met the shareholder requirements because its shares were publicly traded via an electronic trading system. Based on the CJEU judgment, the Dutch court must now prove that the shareholder requirements under the FII regime do not de facto disadvantage non-resident investment funds.

Provided that the tax authorities require proof of compliance for both resident investment funds and non-resident investment funds alike, this would not be deemed discriminatory.

Distribution requirement

Deka argued that despite not having exactly similar distribution requirements as a Dutch FII would have, the rules in Germany were effectively similar and had the same objective for tax purposes (i.e. passing on the taxation of income received through the year to shareholders).

The CJEU here requires Dutch court to verify whether the objectives and purpose of the FII regime lie principally in the taxation of profits of the shareholder in an investment fund. If so, an actual distribution of profits, or profits that are not distributed but are deemed to have been distributed for tax purposes, should be regarded as being in objectively comparable situations.

In summary

The CJEU's position is that criteria to benefit from tax exemptions can be rightfully put in place provided they are not directly excluding non-resident taxpayers or that, in practice, those criteria's burden of proof is more demanding for non-residents. In addition, a deemed distribution of income should be seen as similar to an actual distribution if the purpose is similar i.e. to tax income received in the hands of the shareholders.

Next steps for asset and wealth managers

Foreign investment funds should continue protecting their rights for refund for claims already filed and by filing new claims on a timely basis. We expect further litigation on the compatibility of the FII regime in force from start of 2008. However, the more recent regime de facto has the same objectives and purpose and the principles applied by the CJEU in its recent judgment should be applicable to the 2008 onwards regime as well.

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UK – Illiquid assets and open-ended funds, FCA guidance to come into force in September 2020

Recently, there has been a significant industry focus on open-ended funds with inherently illiquid assets. This began in 2016 after the EU referendum result led to many property funds, including those structured as non-UCITS retail schemes ('NURSs'), suspending their dealing and investors being unable to access their money. More recently, there has been the Woodford fund issue, which resulted in the fund being suspended in June 2019 due to significant liquidity issues. Certain other high profile funds investing in illiquid assets have activated gating requirements and this has attracted significant press scrutiny.

In light of this, the FCA published, on 30 September 2019, its policy statement (PS19/24, the 'PS') on illiquid assets and open-ended funds outlining the final rules and guidance that will apply to NURSs. While the PS applies to NURSs, UCITS funds investing in less liquid assets are also vulnerable to similar issues. The FCA is currently considering whether the rules and guidance should be extended to other types of funds and will consult separately in relation to UCITS funds.

This article focuses on the new rules and guidance in the PS, which will come into force on 30 September 2020. TH PS introduces a new category of NURSs 'funds investing in inherently illiquid assets' ('FIIA') and these funds will be subject to additional requirements as discussed below.

What is an FIIA?

A NURS fund would be classed as an FIIA if:

- The NURS has disclosed to its investors that it is aiming to invest at least 50% of the scheme property in inherently illiquid assets; or
- The NURS has invested 50% of the value of the scheme property for at least three continuous months in the last year in inherently illiquid assets.

In each case, the NURS fund will only constitute an FIIA if it does not apply limited redemption arrangements and is not in the process of winding up or termination.

What is an 'inherently illiquid asset'?

Inherently illiquid assets are defined and includes, in summary:

- An immovable (e.g. real estate);
- An investment in an infrastructure project;
- A transferable security that is not listed or traded on an eligible market;
- Any other security or asset that is not listed or traded on an eligible market and the buying or selling of which is difficult and time consuming; and
- A unit in an FIIA or another fund with substantially similar features.

New suspension requirements

A fund manager is required to suspend dealing (i.e. issue, cancellation, sale and redemption of units) in a fund where there is material uncertainty regarding the value of immovables that constitute more than 20% of the scheme property. However, a fund manager may continue to deal provided they have a reasonable basis for determining that is not in the best interests of investors to suspend. In providing this discretion to the fund manager, the FCA does iterate that 'setting a fair value price alone does not constitute a reasonable basis for keeping a fund open, because this adjustment does not address the uncertainty around the value of the assets which is where the potential for harm to consumers arises.' The depositary of the fund must agree to the fund managers decision to continue to deal. The rules apply to funds with indirect holdings in immovables and not on a look-through basis.

Increased disclosure of liquidity management tools and implementing contingency plans

A fund manager can develop and implement liquidity management tools provided they disclose this to investors and can do so in an appropriate manner.

The manager of the fund is also required to implement and maintain an 'adequate' liquidity management contingency plan for exceptional circumstances and disclose it in the fund's prospectus. The manager must also have written confirmation from relevant third parties identified in the contingency plans. These requirements are additional to existing rules requiring the prospectus of an authorised fund to disclose the circumstances in which redemptions of units may be suspended.

Depositary oversight

Depositary of the fund is required to regularly make its own assessment of the fund's liquidity profile and liquidity risks presented by the fund's scheme property. Furthermore, the depositary of the fund is required to devise procedures for overseeing the liquidity management by the fund manager.

UK – Illiquid assets and open-ended funds, FCA guidance to come into force in September 2020 (cont'd)

Standard risk warning on financial promotions

Any fund categorised as an FIIA must have a standard risk warning in certain financial promotions to retail clients: '[Name of fund] invests in assets that may at times be hard to sell. This means that there may be occasions when you experience a delay or receive less than you might otherwise expect when selling your investment. For more information on risks see the prospectus and key investor information document.'

Enhanced prospectus disclosure

Each fund prospectus must include information including: an explanation of the risks associated with the scheme investing in inherently illiquid assets and how these might crystallise; a description of the tools and arrangements the fund manager would propose to use; and details of the circumstances in which these tools and arrangements would typically be deployed and the likely consequences for investors.

Next steps for asset and wealth managers

The managers of NURSs will need to assess their investment strategies to determine whether any of their funds would be classed as an FIIA, and if so, to ensure they are ready to comply with the new requirements, including making necessary amendments to the fund documentation and liquidity management procedures and tools, by 30 September 2020. This will involve discussions with the depositaries and administrators of funds to ensure they understand their involvement, if any, and can support the liquidity management tools being used. While the rules only apply to NURSs that are FIIA, it would be prudent for other authorised fund managers to assess their funds and review the liquidity and risk management procedures and tools deployed in such funds.

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EU – Impact of Brexit on fund products

With the UK formally out of the EU – Asset and Wealth Managers ('AWMs') are still faced with some uncertainty on the potential impact of the tax drag on their funds' investments.

Have you considered how your fund may be impacted as a result of increased post-Brexit tax charges? There are many ways in which the UK's departure from the EU has the potential to increase the level of taxes paid by funds on the returns on their investment portfolios.

It is important to note that while we are in a transition period (currently this period will end on 31 December 2020), the UK will still be treated as an EU member state by the rest of the member states. The considerations below may give rise to 'Uncertain tax positions' in the fund's financial statements, however this will only apply after the end of the transition period.

UK UCITS funds may suffer increased levels of withholding tax on their investments as they lose their UCITS status

Many European jurisdictions (e.g. France, Spain) apply reduced rates of, or full exemptions from withholding tax on dividends paid to funds authorised as UCITS. UK funds currently authorised as UCITS will no longer be entitled to benefit from this treatment after the end of the transition period, unless an agreement is reached between the UK and the EU in this regard. Higher rates of withholding tax will apply, even where double tax treaties are in place.

UK UCITS funds could find that their EU withholding tax reclaims become more costly as they lose their UCITS status

UCITS authorisation is not required for Fokus Bank reclaims, which are available for 'third country' funds, so, in theory, UK funds should continue to be able to make reclaims. However, in practice, as with non-UCITS funds, such reclaims are likely to be administratively more burdensome as comparisons to domestic funds will be more complex.

UK funds (both UCITS and non-UCITS funds) may suffer increased levels of withholding tax on their investments as they are no longer considered EU recipients

Aside from the provisions of double tax treaties mentioned above, certain jurisdictions have domestic tax provisions that allow reduced or eliminated withholding taxes on interest and dividend payments to recipients in EU or EEA territories. After 31 December 2020 (or the end of the transition period), UK funds (both regulated and unregulated) investing overseas which rely on such domestic provisions may face increased withholding taxes.

EU27 funds may suffer increased levels of withholding tax on their investments

Many EU27 funds rely on the provisions of double tax treaties to reduce or eliminate taxes on their investment returns, either in the form of withholding taxes on dividend or interest payments or taxes on capital gains. In certain cases, the entitlement of investment funds to benefits under double tax treaties is dependent on a significant proportion of the investors in the fund being resident in the EU, based on applying a 'look through' approach to the fund itself. The UK's departure from the EU could potentially impact the ability of EU27 funds with UK investors to benefit from the provisions of such double tax treaties. Similarly, certain treaties allow benefits to apply to entities listed on EU stock exchanges. Without an agreement to the contrary, any EU27 funds relying on a UK stock exchange listing for the purpose of claiming tax treaty benefits could be negatively impacted. The establishment of UK domiciled funds for UK investors which could benefit from the UK's network of double tax treaties may alleviate this impact.

UK funds become less attractive to EU27 investors who invest via a tax wrapper or specific incentivised regimes

A number of European jurisdictions have introduced tax regimes in recent years in order to stimulate investment by local investors (e.g. French Plan d'Epargne en Actions ('PEA') regime) or by overseas investors in their local markets (e.g. Italian tax reporting regime). While initial steps have been taken by some governments to limit the impact of the UK's departure from the EU on these regimes, their application could be significantly restricted without further action.

Practical impact on investment mandates

Tax implications aside, Brexit also has the potential to impact investment behaviour more broadly. Where investment mandates dictate minimum thresholds of investment in EU instruments and derivatives, investment portfolios may need to be reconfigured in the event that the UK is no longer considered to be within the EU/EEA in this context. This could be of particular concern for pension funds and for UCITS funds investing in UK-domiciled funds, given these will no longer qualify as UCITS for investment restriction purposes, however other funds may also be impacted

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US – Arrival of Brexit puts treaty claims at risk

How Brexit affects treaty qualification

A resident of a country that is a party to a US income tax treaty and wishes to avail itself of the treaty benefits generally must satisfy the treaty's anti-treaty shopping provisions, found in the limitation on benefits ('LOB') article of most US tax treaties. One way companies can meet this test is based on ultimate ownership by an owner that, under a US tax treaty with the owner's country of residence, would qualify for an equivalent benefit if the US income were paid directly to that owner (an 'equivalent beneficiary'), as well as by satisfying a base erosion test. This is the 'derivative benefits' test.

Certain treaties define a qualifying owner for this purpose is by reference to a person being a resident of an EU member state, or of a country that is a party to the North American Free Trade Agreement ('NAFTA'). There are 16 in-force US treaties that contain a similar description: those with Belgium, Bulgaria, Denmark, Finland, France, Germany, Iceland, Ireland, Luxembourg, Malta, Mexico, Netherlands, Spain, Sweden, Switzerland, and the United Kingdom.

Now that the UK is not a member of the EU, a UK investor that has been an equivalent beneficiary may no longer meet that definition. Although there is uncertainty about how transition rules related to Brexit may apply, companies relying on a UK investor being a resident of an EU member state should evaluate the need for further treaty analysis. **This could particularly impact Irish funds that invest in the US and receive treaty benefits.**

Discretionary grant of benefits

The LOB article also includes a provision allowing a company that does not meet the objective criteria of the LOB article to obtain a determination from the Competent Authority – i.e., for the United States, the Deputy Commissioner (International) of the IRS Large Business and International Division – that the company's establishment in the treaty jurisdiction did not have the principal purpose of accessing the treaty (a 'discretionary grant').

A potential course of action for companies whose treaty qualification may be impacted by Brexit would be to request from the IRS a discretionary grant of treaty benefits. However, this is a formal process, and it typically takes a year or more to obtain a determination from the Competent Authority. In addition, the outcome is uncertain.

Furthermore, although a taxpayer may request that discretionary treaty benefits be granted with retroactive effect, until such a grant is obtained, payments of dividends, interest, royalties, and any other similar US-source payments may require tax to be withheld at a rate of 30% of the gross amount of the payment. Impacted taxpayers may want to consider alternative protective measures that may avoid this result.

Next steps for asset and wealth managers

Taxpayers should review their structures and evaluate the need for further analysis and alternative ways to satisfy the requirements for treaty eligibility. For example, by seeking a determination from the IRS under the competent authority route.

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UK – Franked investment income: why are HMRC writing to UK investment funds about their pre-2009 UK CT returns?

HMRC have been writing to some UK investment funds in respect of their pre-2009 corporation tax return filings, but why? It's because UK funds that received EU dividends before 2009 may be entitled to a refund of the UK corporation tax they paid because of a ruling of the Supreme Court in favour of the tax payer in Prudential Assurance Company Limited v HMRC [2018] UKSC 29.

The quantum and timing of that refund will likely be affected by the actions you take now. For most UK funds, this means knowing what has previously been submitted to HMRC; reviewing to confirm accuracy, and substantiating with amended filings where necessary.

Back to basics

HMRC have recently issued a circular to UK funds that deals with statutory claims for UK Double Tax Relief ('DTR') on foreign dividends made in periods up to 2009. Post 2009 the rules changed to exempt most overseas dividends from UK corporation tax, hence those more recent periods are outside scope.

Many UK funds either exempted EU source dividends from tax; claimed withholding tax relief ('WHT'); claimed Underlying Tax relief ('ULT') (this is the corporation tax paid by the overseas dividend payer company in its home jurisdiction); or a combination of these options.

This is the first indication from HMRC as to how they will deal with claims filed and sets out the fact patterns they consider should lead to refunds of UK corporation tax. It also sets out HMRC's view on fact patterns that won't give rise to a refund for the UK fund.

What does the circular say about how claims will be dealt with?

HMRC's circular deals with statutory claims for UK tax relief on foreign dividends (not high court claims but those with such claims should consider the statutory routes taken alongside those claims as well). As it sets out how HMRC will deal with claims based on the different tax return filing and subsequent claim fact patterns they have seen, it is important for all UK funds to first understand for each sub-fund and year:

- what they submitted to HMRC in their original UK corporation tax return filing;
- the nature of any claims subsequently submitted to HMRC and when they were submitted;
- whether any refunds of WHT have been received by the fund under CJEU discrimination reclaims (Fokus Bank) and when refunds were received; and
- the completeness and integrity of the supporting information that was submitted to HMRC.

Next steps for asset and wealth managers

Given HMRC have now set out their view, managers of all UK funds that existed pre-2009 should take action now to protect their position and enhance their prospects of obtaining a UK tax refund. If no action is taken, UK funds may find themselves on the back foot in dealing with HMRC closure notices or settlement proposals in short timeframes. In some scenarios where UK funds have received refunds of overseas WHT they may even have an increased tax liability due to HMRC. Every scenario we've outlined may have an impact on the pricing NAV of the fund.

Regardless of the historic position, and whether or not you have received HMRC's briefing circular, we would encourage you to contact your usual PwC team or one of our specialists below to discuss further.

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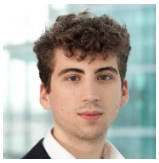

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