Keeping up with Alternative Investment Funds

March 2020

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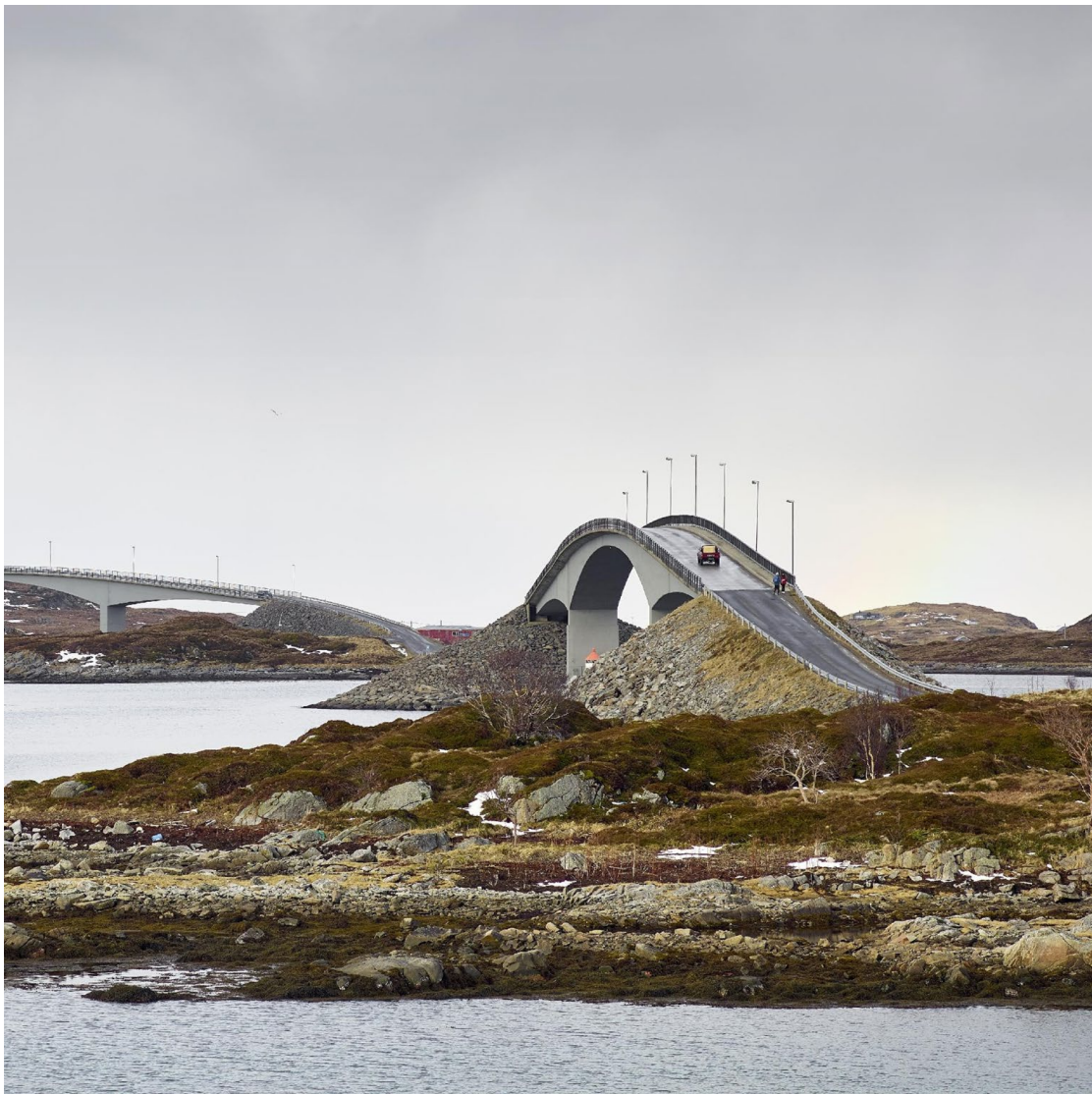

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Introduction

Opening blog

Welcome to our March edition of Keeping up with Alternative Investment Funds, The news cycle in February was somewhat dominated by the Covid-19 outbreak. While the focus is inevitably, and rightly, on the significant human cost of the outbreak, Fund managers 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 home working and travel restrictions.

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 Alternative Investment Fund managers will no doubt be the UK Funds Regime and the Overseas Funds Regime and UK Asset Holding Companies consultation papers.

We were delighted to hold an Alternative Investment Fund Network Conference on 25th February with over a 100 AIF clients in attendance. The topics of discussion covered at the event included:

- **21st Century fund structuring –** We discussed current structuring trends amongst European close-ended funds across different asset classes: Private Equity, Credit, Real Estate and Infrastructure, as well as the challenges faced by funds in light of BEPS, the EU Anti Tax Avoidance Directive and Brexit.
- **21st Century Manco structures and issues –** We discussed how the management group structure has evolved over the last decade and how governance and control oversight are the new normal for Manco structuring. This included an in depth review of the impact of BEPS, Brexit, onshoring activities, AIFMD, business travel and higher tax authority, and investor scrutiny.
- **OECD latest proposals - Transfer Pricing and HMRC Activity & Operational Resilience -** The panel facilitated a lively debate about the more recent tax authority audit activity that has been seen across the asset management sector, both internationally and in the UK. There were additional discussions around the increased focus by HMRC on implementation of transfer pricing policies, as well as the level of evidence that is now being requested during transfer pricing disputes. Finally, the important interaction with client's internal governance and controls was also discussed, and the role that technology can play in this.
- **Dealing with disruption panel -** The panel discussed a wide variety of issues which we can expect to cause disruption to the alternatives industry over the next few years. Topics discussed were ESG investing and the impact of climate change, the impact of technology on the future operating model and the evolving nature of the workforce.
- **Keynote speech by Lord Gavin Barwell - ex Chief Advisor to Theresa May in Downing Street -** Lord Barwell presented a speech about his expectations of the future political environment in the UK, following the Conservative's general election victory last year. He outlined what we can expect to see from British politics over the next few years. Some of his more striking predictions include a less free market Conservative party, climate change moving up the agenda, and push by the Government to increase the tax intake.

On to this month's edition, 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. As well as this, the March edition will focus on the following:

- Impact of Brexit on fund products
- Arrival of Brexit puts treaty claims at risk
- Illiquid assets and UK open-ended funds
- OECD – MLI dual residence, a new way to resolve tax residency disputes
- Mexico – Tax Update for transparent funds investing in Mexico

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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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.

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.

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.

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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Arrival of Brexit puts treat claims at risk

In brief

Brexit has many social, political, and economic implications, one seemingly collateral effect is its potential impact on qualification for treaty benefits for some UK-parented groups under certain US income tax treaties.

In detail

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.

In a typical fact pattern, a UK tax resident publicly traded company owns (directly or indirectly) a European subsidiary, e.g., as a subsidiary that is tax resident in Luxembourg. The Luxembourg subsidiary receives US-source payments (e.g., interest) from a US affiliate. If the interest were paid directly from the US affiliate to the UK parent, under the UK-US income tax treaty, provided all requirements are met, US taxation of the interest is limited to a rate of 0%. Under the Luxembourg-US income tax treaty's derivative benefits provision, the Luxembourg subsidiary may qualify under the LOB based on it being 100% owned by the UK parent, to the extent that the UK parent is a resident of a state that is an EU member State, and a base erosion test is satisfied.

Now that the UK is not a member of the EU, a UK company that has been an equivalent beneficiary with respect to a subsidiary may no longer meet that definition. Although there is uncertainty about how transition rules related to Brexit may apply, companies relying on a UK owner being a resident of an EU member state should evaluate the need for further treaty analysis.

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 & 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.

Similar issue posed by the USMCA for US-parented groups

A similar, but somewhat distinct, issue is posed by the new United States-Mexico-Canada Agreement (USMCA), which will replace NAFTA when it enters into force, an event that is expected to occur in the coming months. See our recent insight that includes a discussion of this topic. The issue with respect to the USMCA may have a broader impact because the derivative benefits test is often relied upon for treaty qualification of non-US subsidiaries of US multinational parent companies, as well as by subsidiaries of Canadian parent companies. Mexican-parented groups may be similarly impacted.

Next steps for asset wealth managers

Amid the varied consequences potentially wrought by Brexit, taxpayers relying on applying the benefits of a US income tax treaty based on having a UK tax resident parent company that satisfies certain requirements may no longer qualify. The same may shortly be true for US, Canadian, and Mexican-parented groups. Taxpayers should review their structures and evaluate the need for further analysis and alternative ways to satisfy the requirements for treaty eligibility.

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Illiquid assets and UK open-ended funds

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 suspending their dealing and investors being unable to access their money. More recently certain high profile funds investing in illiquid assets have activated gating requirements and this has attracted significant press scrutiny.

In light of this, the FCA after following its consultation process published, on 30 September 2019, its policy statement (PS19/24) on illiquid assets and open-ended funds outlining the final rules and guidance that will apply to non-UCITS retail schemes ('NURSs') (the 'PS'). The FCA Dear Chair letter dated 4 November 2019 was also issued by Nick Miller, Head of Asset Management Department, to the chairs of authorised fund managers, which stated 'effective liquidity management is an irreducible, core function for all open-ended funds' and all managers should review their liquidity management arrangements against the FCA good practice. It is clear that the FCA is concerned about liquidity in open-ended funds (which includes property funds, infrastructure funds, credit funds or hedge funds). It is likely that there will be further regulatory reforms in relation to funds investing in illiquid assets.

This article focuses on the new rules and guidance in the PS, which will come into force on 30 September 2020. In summary, the 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 3 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.

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

Illiquid assets and UK open-ended funds (cont'd)

Next Steps

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, in light of the Dear Chair letter it would be prudent for all alternative investment fund managers to assess their funds (whether it be property funds, infrastructure funds or credit funds) and review the liquidity and risk management procedures and tools deployed in such funds.

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OECD - MLI dual residence, a new way to resolve tax residency disputes

In brief

The final action of the BEPS Action Plan, Action 15, related to the development of a multilateral instrument ("MLI") that countries could use to modify existing bilateral treaties in order to implement international tax measures introduced by the The Organisation for Economic Co-operation and Development ("OECD"). One of the MLI articles amends the residency tie-breaker in a Double Tax Agreement ("DTA"), if adopted by both jurisdictions party to the DTA, to give tax authorities the right to make a ruling between themselves.

Where this is the case (note that the UK is a jurisdiction which has adopted this amendment), it may be necessary to enter into a mutual agreement procedure ("MAP") in accordance with the relevant DTA. Action may be required in order for a company to maintain its residence (and access to other treaty benefits).

This could be relevant for companies prima facie deemed to be tax resident under domestic law in more than one jurisdiction. A typical scenario, for example, might arise in relation to Irish incorporated companies which are UK tax resident by virtue of management and control. Equally, the reverse scenario (i.e. UK incorporated but managed and controlled in Ireland) would also require consideration of a MAP.

Ultimately, the MLI could lead to more uncertainty in determining tax residency. It could potentially also give rise to a change in tax residency, resulting in a 'migration' and therefore possible exit charges.

In detail

Article 4 of the MLI gives jurisdictions an option to amend the residency tie-breaker in a DTA to give the tax authorities the right to make a ruling with regards to cases of corporate dual residence. Where this is the case (note that the UK has adopted this amendment), it may be necessary to enter into a MAP in accordance with the relevant DTA.

Timeline

In order for the MLI to apply to, and modify, any specific existing treaty, both parties must have adopted this amendment in the MLI framework. Generally, the amended tie-breakers will apply in relation to a treaty in the accounting period commencing on or after 6 months from the latest of the dates on which the MLI enters into force for each of the contracting jurisdictions.

For example, with respect to the UK / Ireland DTA, the effective date of the MLI was 1 November 2019 by virtue of the entry into force of the MLI being 1 October 2018 and 1 May 2019 respectively.

Relevant fact patterns

This may be relevant where a company is deemed to be resident in two jurisdictions. Generally, this will be the case if a company is established in one location but managed and controlled in another, and their tax residency has previously been determined by the existing management and control tie-breaker test in the DTA.

However, the above scenario could be impacted where such a company has real economic substance (e.g. employees, premises etc.) in the jurisdiction of its incorporation. Previously, such a scenario would likely have resulted in the company being treated as tax resident in the jurisdiction in which it was managed and controlled (e.g. the UK), with a permanent establishment arising in its jurisdiction of incorporation and business activity (e.g. Ireland).

Per HMRC's manuals, in their view a deciding factor for a UK treaty with competent authority as the tie-breaker for residency would be the location of major economic linkages - i.e. where the company's real business, premises and staff are. In our example case, it is possible that the company would be found to be tax resident in Ireland for the purposes of the treaty as a result of the competent authority process. Under UK law, where a company would be found not to be UK resident for the purposes of a treaty, even where treaty benefits are not sought, the company will be treated as resident outside of the UK under domestic law.

Tax authority guidance

HMRC have updated their International Manual to state that where the old effective management test previously determined a company's status, that status will remain the same, despite the new tie-breaker of competent authority agreement being introduced, unless there is a material change in the facts. However, other tax authorities (e.g. the Irish Revenue) have not provided such assurance.

Unless both jurisdictions have agreed grandfathering, then a company is potentially dual resident even if it historically wasn't. This may have adverse consequences under domestic law in both jurisdictions and also could prevent access to other tax treaties (e.g. if a company becomes dual resident in Ireland / U.K., then it may not be able to access Irish or U.K. tax treaty benefits with other jurisdictions). Therefore companies should not risk leaving this unresolved.

The manual also explains that where arrangements violate the Principal Purpose Test (PPT), then the residence determination may be revisited and HMRC may seek a new determination once the modification comes into effect.

Potential impact

In many instances, the new approach means a company may be under the control of two sets of tax authorities, and there is therefore a potential for taxpayers to get a different answer from that they expect.

The most immediate of impacts where tax residence has 'migrated' to another location would be the potential for an exit charge to arise.

OECD - MLI dual residence, a new way to resolve tax residency disputes (cont'd)

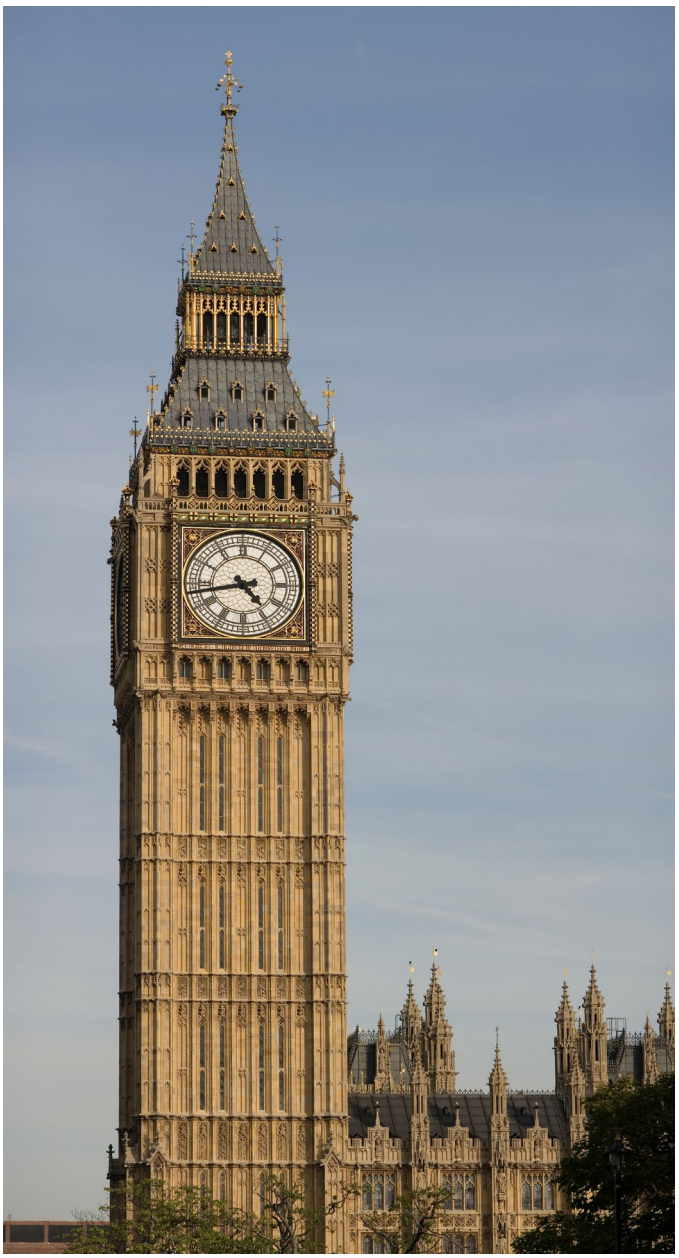
This difference in approach may impact project timelines, cash tax flows, and create uncertainty for stakeholders. There is no way to accurately estimate the time it will take competent authorities to agree the residency of a company, but it is clearly something that businesses will need to factor into their project plans and cash flow forecasts when awaiting such a determination. Businesses should therefore assess their current residence and whether the treaty they rely on has amended the dual-residence tie-breaker.

These issues may be resolved if the tax authorities choose to apply a decision retroactively.

Next steps for alternatives

At the time of writing, the new tie-breaker clause has been brought into effect for 8 of the UK's DTAs (India, Ireland, New Zealand, Poland, Russia, Serbia, Slovakia and Slovenia) which have previously relied on another method (e.g. effective management test). Other DTAs for which the UK is not a party may also be impacted. The total number of DTAs that are impacted will no doubt increase as further instruments are ratified and come into effect.

It is important to review your structures to identify the entities / funds that are reliant on existing tie-breaker clauses, that have been modified via the MLI. If you are impacted by these changes, a request for a decision by the relevant tax authorities should be filed as soon as possible.



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Mexico tax update for transparent funds

In brief

The recently enacted 2020 Mexico Tax Reform ("Reform") significantly modifies the taxation of income earned through foreign funds and other entities qualifying as fiscally transparent in their incorporation jurisdiction investing into Mexico.

In this regard, Investment funds often consolidate investments through foreign fiscally transparent vehicles that do not have legal personality of their own ("Foreign Transparent Vehicle"), which, in turn, invests into Mexican entities. The Reform affects the tax treatment of Mexican source income received by the Foreign Transparent Vehicle, as well as the deductibility of the cross-border payments made by the Mexican entity. In contrast to the Reform´s general effective date of January 1, 2020, the changes to the taxation of Foreign Transparent Vehicles would be applicable until January 1, 2021.

In detail

Taxation of Alternative funds qualifying as fiscally transparent prior to the Reform

Mexico is a high withholding tax jurisdiction with an extensive network of income tax treaties providing reduced withholding tax rates. Prior to the Reform, a Foreign Transparent Vehicle that did not carry out business activities in Mexico, generally, would not be treated as an entity for tax purposes, allowing the individual members to assert their own taxation rights.

However, a more specific rule, Article 171, limited look-through treatment prior to the Reform for a Foreign Transparent Vehicle that is either not subject income tax or subject to an effective tax that is less than 75% of the tax that would be triggered as a Mexican tax resident (REFIPRE). Article 171 of the Mexican Income Tax Law (MITL) imposes a 40% withholding tax on Mexican source income paid to, among others, a Foreign Transparent Vehicle that is subject to a REFIPRE. The Article 171 high withholding taxation, however, does not apply to the payment of dividends and interest on bonds qualifying for the 4.9% or 10% rate under domestic legislation.

An exception to Article 171 was available based on the publication of two Miscellaneous Rules (which are renewed on a yearly basis and are issued at the discretion of the Mexican Tax Authorities). The first rule provides that the 40% withholding tax will not apply to the payment of Mexican source income to an unrelated party or to a related party that is tax resident in a country with a broad exchange of information agreement, a list which includes over 60 countries. In the context of a Foreign Transparent Vehicle, a second rule provides that a Foreign Transparent Vehicle will have access pass-through treatment for determining Mexican withholding tax if certain requirements are met ("Pass-Through Rule").

The Pass-Through Rule allows a Foreign Transparent Vehicle to be fiscally transparent for Mexican tax purposes if it is formed under the laws of a jurisdiction with a broad exchange of information agreement in place with Mexico. As a result of the Pass-Through Rule a foreign resident that invests in Mexico through a Foreign Transparent Vehicle has had clear requirements for Mexican pass-through treatment. The referred administrative rules have been renewed and remain applicable during FY 2020, however, as mentioned before as of January 1, 2021 the new rules introduced in the text of the amended Mexican Income Tax Law would become effective.

2020 Mexico Tax Reform

Effective January 1, 2021, Article 4-A of the MITL provides that a Foreign Transparent Vehicle will be taxed as a separate entity for Mexican income tax purposes if it is not a tax resident in either its jurisdiction of formation or where the effective seat of management is located. This law change directly contradicts the Pass-Through Rule, and upon its effective date, the new law will override the look-through treatment provided by the Pass-Through Rule. On its own, this statutory change would significantly increase the tax burden of many investment funds with presence in Mexico.

However, as part of the legislative discussion leading up to the Reform, Congress included Article 205. This article provides that a Foreign Transparent Vehicle is eligible for pass-through treatment for Mexican tax purposes if the vehicle meets three requirements: it manages private equity, it invests in Mexican entities and it is fiscally transparent in its jurisdiction of formation. The fiscal transparency provided in Article 205 for Mexican income tax purposes will only apply for specific categories of passive income: interest, dividends, capital gain and lease payments for immovable property. Article 205 provides a narrower benefit than the Pass-Through Rule, which allows for fiscal transparency in determining the withholding tax on all Mexican source income and is not limited to private equity investments.

If a Foreign Transparent Vehicle is eligible for pass-through treatment under Article 205, its members can be subject to tax in Mexico to the extent that the following requirements are met:

1. The Foreign Transparent Vehicle´s administrator or Mexican legal representative provides a registry of its members or partners during the last fiscal year, including any variances to the members or partners during that period. Documentation proving the tax residency of the members must also be provided. If a member is an international organization or pension fund, it can provide its formation agreement in lieu of a tax residency certificate.
2. The Foreign Transparent Vehicle should be formed in a jurisdiction with which Mexico has a broad exchange of information agreement in place.
3. The partners or members of the Foreign Transparent Vehicle and its manager should be resident in a country with which Mexico has a broad exchange of information agreement in place.

Mexico tax update for transparent funds (cont'd)

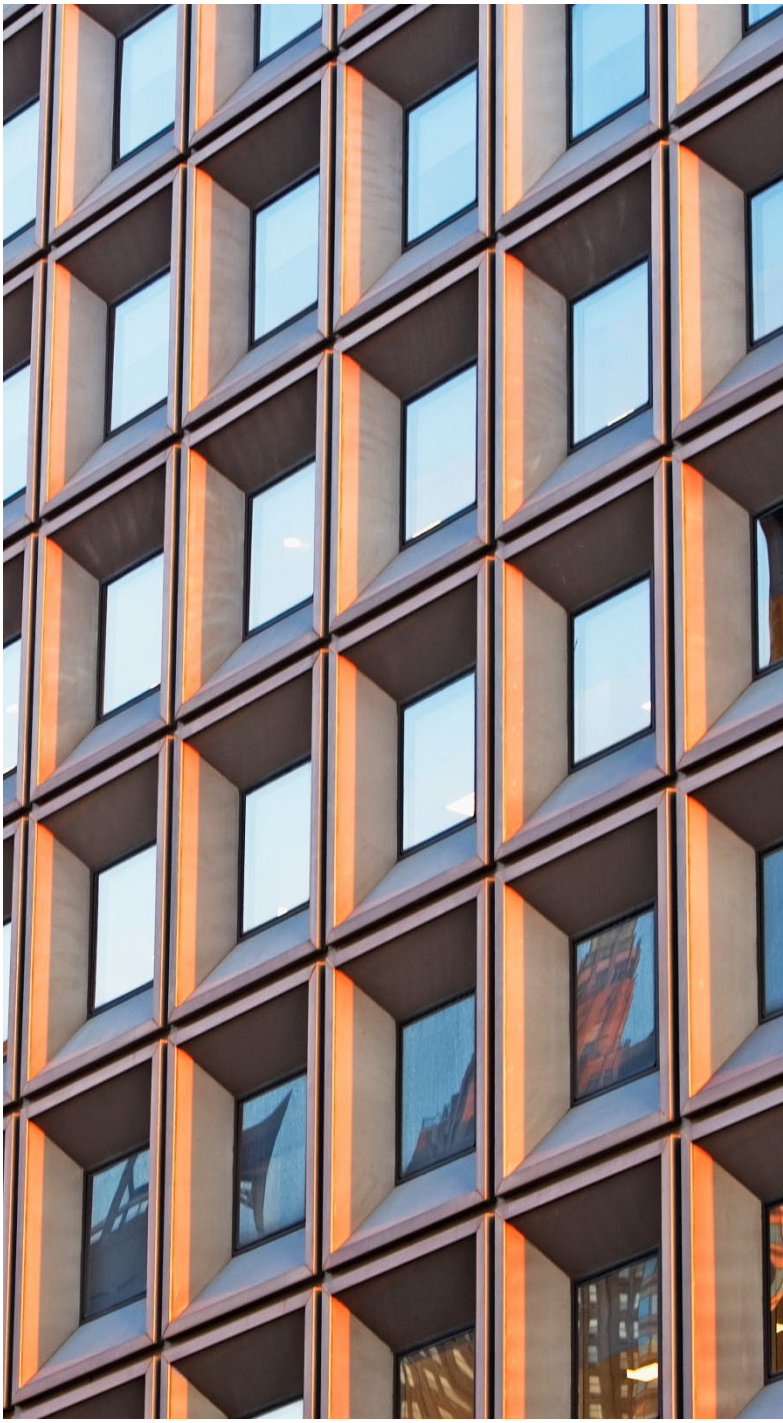
4. The partners or members of the Foreign Transparent Vehicle should be the beneficial owners of the foreign legal vehicle's income. The MITL does not define the term "beneficial owner". Currently, this term is used only in the context of income tax treaties for which the OECD Commentary is regulated as appropriate guidance in defining terms not otherwise defined in the treaty or the MITL. Article 205 is not a tax treaty related article. However, the OECD Commentary should still be relevant as doctrinal guidance on the definition of such term.
5. Income received by the Foreign Transparent Vehicle should be accrued by its partners or members. If the members or partners are subject to tax in Mexico as residents or a permanent establishment, the income must be subject to tax in Mexico under the Mexican equivalent of Subpart F rules.

If the requirements established in items 1, 3, 4 or 5 are met only by certain partners or members, the Foreign Transparent Vehicle will only be fiscally transparent in proportion to the ownership percentage of such partners or members.

Foreign investors should also consider the effect of the loss of fiscal transparency on the analysis of the Article 28 non-deductibility rule for cross-border payments by a Mexican entity to a foreign related party, including a Foreign Transparent Vehicle subject to a REFIPRE. If a Foreign Transparent Vehicle does not meet the requirements of Article 205 or receives income other than the protected categories of income, it may be subject to tax as an entity with a low effective tax rate rendering the payment non-deductible in Mexico under the newly enacted Article 28.

The takeaway

Mexican investments structured through a Foreign Transparent Vehicle may no longer benefit from fiscal transparency effective January 1, 2021. The statutory exception provided for private equity funds requires that controls be put in place to gather and file with the Mexican government information regarding the individual members of the fund. Furthermore, the fund structure should be assessed before and after the change to fiscal transparency under the Article 28 non-deductibility rule to understand any impact to the effective tax rate of the Mexican entities. For new investments into Mexico, funds should consider structures that meet the new requirements for fiscal transparency and the deductibility of payments by the underlying Mexican entities.



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