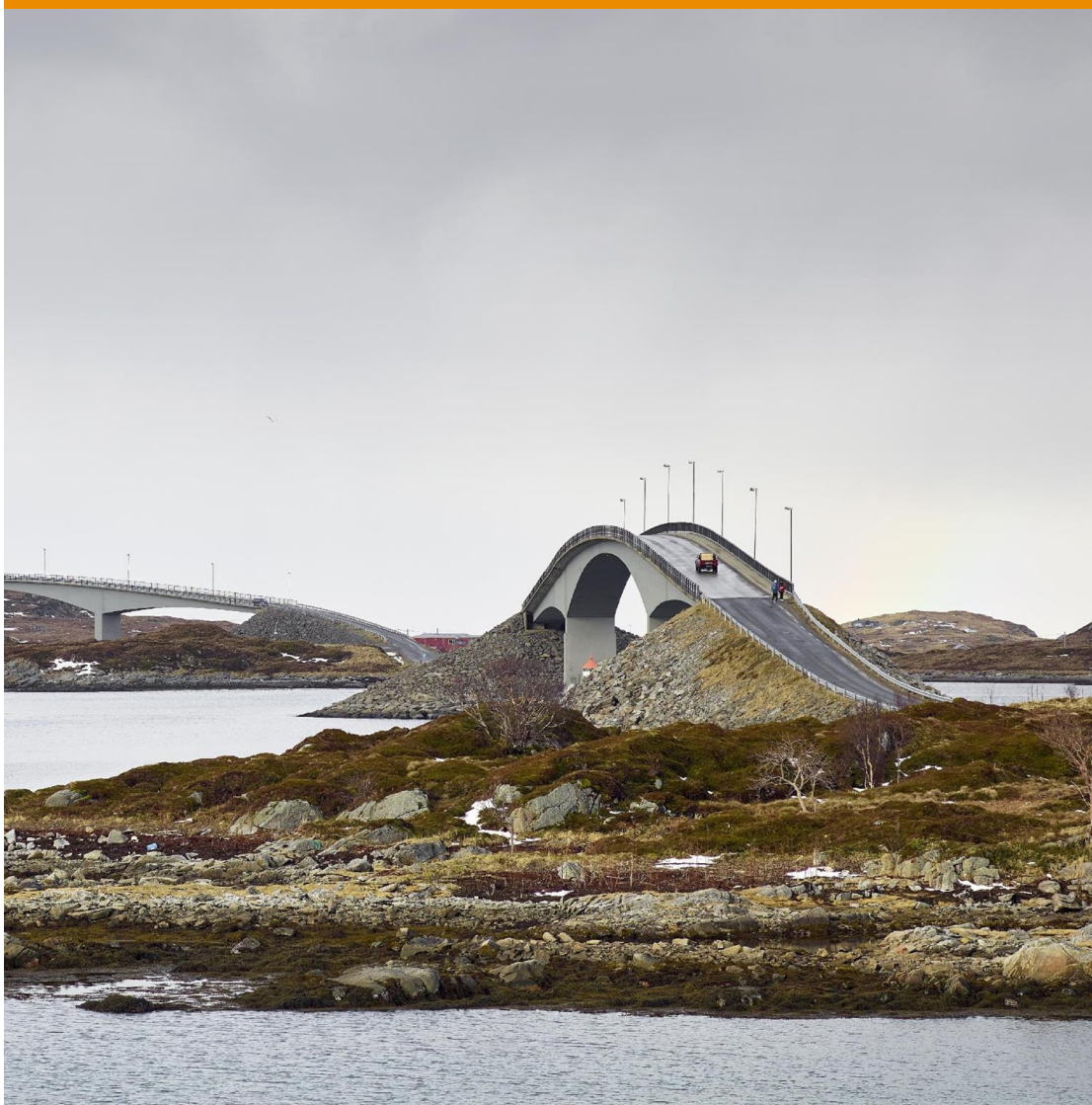
Keeping up with Alternative Investment Funds

January 2020



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Introduction

Welcome to our next edition of Keeping up with Alternative Investment Funds. As we came to the end of a busy 2019, readers will no doubt be reflecting on a year which has seen extensive change across the Alternative Investment Fund industry and the tax landscape alike. 2020 promises to be no different, with political, regulatory, legislative and technological change all on the agenda.

We have entered into the new year with a new Conservative government whose manifesto Alternative Investment Funds managers will no doubt have been keeping an eye on. We have included below a high level summary of the changes proposed by the Conservative party and what Alternative Investment Fund managers will need to think about following 12th December elections. The Conservatives promised to:

- Hold the current rate at 19% reversing the previously enacted reduction to 17% planned for 2020.
- Increase the rate of Research and Development relief from 12% to 13%.
- Implement Digital Service Tax.
- Freeze the rate of personal income tax and NIC.
- Reduce business rates following the review.

Following the UK's parliamentary elections we have some clarity regarding Brexit. The Government has just announced plans to remove the ability to extend the transition period beyond 2020.

Away from politics and Brexit, 2020 will see the full implementation of the EU Mandatory Disclosure Rules as the reporting requirements kick in; we are seeing Alternative Investment Fund managers really start to focus their efforts on ensuring readiness for full implementation in the summer, and it's vital that the extent of the compliance burden is not underestimated.

2019 saw members meet and approve of plans for a legislative proposal to require public country-by-country reporting ('CBCR') of taxes paid by multinationals, meaning companies with revenue over a certain threshold will be required to publicly publish more detailed information on taxes paid in each EU jurisdiction, rather than aggregated figures. It will certainly be worth keeping an eye on how this proposal evolves in the new year.

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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.

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.

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Partnership tax return reporting – Changes to the number of returns potentially required and the UTR process

Introduction

HMRC have now published further guidance on the partnership reporting measures in the Finance Act 2018, in particular those relating to investment partnership reporting.

Reporting for investment partnerships has always been a complex and judgemental area; primarily because the partnership rules have historically been written with trading partnerships in mind. Finance Act 2018 represented the culmination of a lengthy process – which started with the August 2016 Consultation (Partnership taxation: proposals to clarify tax treatment). Finance Act 2018 contains the latest set of changes affecting most partnerships and they have the potential to introduce complexity and increase the administrative burden.

HMRC's proposals attempt to simplify the position, but there remain areas that will require additional consideration. We explore what some of the key changes for investment partnerships will mean in practice.

Partnerships as partners (tiered structures) allocation bases

Before FA 2018, partnerships with companies and individuals as partners have produced partnership computations on both a corporation tax (CT) and income tax (IT) basis.

The changes in FA 2018 mean that for tiered partnerships (where a partner is itself a partnership) profits and losses require to be calculated under four allocation bases - UK resident IT, non-UK resident IT, UK resident CT and non-UK resident CT unless the identity of the ultimate indirect partners is known. In practice obtaining the identity is difficult and, in most cases, partnerships would typically end up providing statements covering all bases.

HMRC propose that non-resident bases on IT and CT will not be required if the partnership income will not produce a UK tax liability for indirect non-UK resident partners. This should be the case for most Private Equity partnerships (without UK real estate) and is a welcome clarification.

There are still some judgemental areas. For instance, the guidance doesn't change the position for direct partners and there is now a requirement for both IT and CT computations where full information is not available in respect of indirect partners, potentially restricting flexibility where it would otherwise be clear from the direct partners that a particular basis is not required.

Partnership income sources

Historically partnerships have reported total income and gains received from underlying partnerships as a single source in the partnership return. The new requirement is to report each underlying source separately and to provide a separate partnership statement for each underlying source. This can lead to multiple partnership statements where a partnership is a partner in one or more other partnerships such as a carry partnership that is a partner in various parallel funds, but the issue is most marked for fund-of-funds which may have multiple underlying partnerships.

HMRC have recognised these concerns and they propose that where a partnership receives 5 or more separate income sources from other partnerships, the information can be provided on a separate HMRC approved template. We understand that this is a temporary fix until HMRC have developed a digital solution. There however remain concerns over how partnership software will manage multiple partnership statements as well as the difficulties of identifying the various sources and the detailed information to be provided in the template for complex structures.

Non-resident UTRs

FA 2018 marked the end of an era in relation to the use of the 'dummy' UTR for non-UK resident partners. The dummy UTR was originally introduced to avoid non-resident partners having to apply for a UK UTR when there was no underlying UK tax liability.

FA 2018 broadly provided access to a non-resident UTR in legislation (as opposed to guidance) where a partner meets a few conditions including the fact that they had been reported under FATCA or CRS. This clearly left a gap as some partners do not need to be reported under CRS/FATCA.

Partnership tax return reporting – Changes to the number of returns potentially required and the UTR process (cont'd)

HMRC have provided alternative UTRs in their guidance for the following categories of non-resident partners that are not required to be reported under CRS/FATCA provided certain conditions are met: partners other than reportable jurisdiction persons, partners resident in non-CRS/FATCA jurisdictions, partners who meet the CRS threshold exemption for reports. The first category is intended to encompass a range of entities that do not need to be reported. In these cases, the partnership must also provide for each of the partners a foreign tax reference number (or equivalent) and the partners' country of tax residence. Again, a template will be provided to capture this information.

Practically this means that there will be different UTRs, which clearly increases complexity in terms of confirming the CRS/FATCA status and also the risk of applying an incorrect UTR.

Conclusion

The main changes in the guidance are welcome, as noted, however there will still be a period to understand how the new procedures will apply, their practical implications and how penalties for innocent errors will be applied.

It's worth remembering in the partnership reporting context, these changes are beginning to form the important groundwork for the government's Making Tax Digital (MTD) programme with increased transparency and traceability at its core.

Next steps for Alternative Investment Funds

- Understand the investor base to ascertain if calculations required under all four bases.
- Identify investors that relied on old 'dummy' UTR and analyse their CRS/FATCA reporting status.
- Collate foreign investor details for "non-CRS reported" partners i.e. tax references or equivalent, legal and residence status etc.
- Obtain income and corresponding partnership details if income received from underlying sources and clarify whether there are less than five sources.

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Spain - Application of the CJEU Danish cases to withholding tax

Introduction

In October 2019, Spain's Central Economic Administrative Tribunal (Tribunal Economico-Administrativo Central, TEAC) issued a decision applying the position taken by the Court of Justice of the European Union (CJEU) in the so-called Danish cases, for the first time. The TEAC is part of the Spanish tax administration and the decision is relevant for the withholding tax treatment of cross-border payments of interest and royalties. It may result in a more restrictive position of the Spanish tax authorities going forward and is one of the first domestic case law examples of the beneficial ownership concepts arising from the Danish cases being applied by EU member states.

Background

In this case, a Spanish company paid interest to its Dutch parent. The Dutch parent was controlled by a Curaçao entity and indirectly by an entity resident in Andorra (altogether the "Group"). The sole shareholder of the Andorran entity was an individual also tax resident in Andorra. The Group had back-to-back debt financing.

The taxpayer had recognised the Dutch parent was not the beneficial owner of the interest proceeds and acknowledged the structure being artificial.

Spain's interest withholding tax exemption

- Spain levies 19% withholding tax on interest payable to non-residents. Interest payable to EU lenders (related or unrelated) is exempt from withholding tax if payment is not made through a blacklisted tax haven.
- This withholding tax exemption pre-dates the EU Interest and Royalties Directive and it is broader in scope.
- The law does not include a beneficial ownership requirement for the tax exemption to apply.
- In a landmark judgment in 2017, Spain's National Court concluded that the Spanish tax authorities cannot deny the withholding tax exemption on the basis of a lack of beneficial ownership.
- They should apply Spain's general anti-avoidance rule and its special process.

Analysis by the Tribunal

The position taken by the Tribunal is different from the 2017 judgment in terms of the weight given to beneficial ownership. The Tribunal concluded:

- The Andorran entity was the beneficial owner of the payments. Andorra is not an EU member, so the interest cannot benefit from the withholding tax exemption. It also did not have a tax treaty in place with Spain at the time of the relevant facts.
- Beneficial owner is the person with real and effective rights to make decisions, exercise control and benefit from the proceeds. The beneficial ownership requirement in the EU Directive therefore, applies to the interest withholding tax exemption under Spanish law, based on the purpose and objectives of the EU Directive. It is irrelevant that the law does not require beneficial ownership.

Points to take away

This decision is likely to have broader impact for withholding tax on interest payable to EU lenders.

It is uncertain if Spanish courts would maintain the interpretation of the 2017 National Court judgment or follow the recent Tribunal decision, if this case or similar ones are heard on appeal.

The Spanish tax authorities may also take a more aggressive interpretation of beneficial ownership, in line with the Danish cases, for dividend withholding tax purposes.

Next steps for Alternative Investment Funds

- Spanish tax inspectors may automatically deny tax exemptions using the arguments of the Tribunal. It is important to review existing cross-border structures involving back-to-back group financing into Spain.

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French Digital Service Tax - Under the spotlight

Background

As has been widely reported in the press, on 2 December, the US Trade Representative's office (USTR) issued a report on its Section 301 investigation of the French Digital Service Tax (DST). The report determined that the French DST is discriminatory as against US digital companies, has retroactive application inconsistent with prevailing tax principles, creates burdens by applying to revenue rather than income, is unconnected to physical presence in France, and targets the digital economy for unfavourable tax treatment. USTR consequently recommends imposing ad valorem duties of up to 100 percent on certain French products (set forth in an appendix to the report), as well as a potential fees or restrictions on French services (which might impact the financial sector, among others).

Key messages

Clearly this is a significant development that could have a bigger economic impact than tax, and have broader ramifications than trade between France and the US - particularly if the EU acts together to retaliate against any US measures.

While a final decision on whether to impose tariffs of €2.4bn of French exports is only just being finalised, the French DST is already in force and applies to post 1 January 2019 revenues.

Many other countries are in the process of implementing similar DSTs. Among others Italy, Turkey and Austria have passed similar measures in the last few weeks of 2019, with commencement dates of early 2020. The UK intends to legislate in time for application from 1 April 2020 in its March 2020 Budget. The breadth and base of these measures could result in additional investigations from USTR.

The developments could also either undermine or accelerate agreement at the OECD, where nearly 140 countries are seeking to agree reforms to the international tax system. This will be impacted by a number of factors (including the final US decision, any French/EU retaliation, other countries' DST implementations) and must be closely watched.

Next steps

USTR invited public comments on the appropriateness of its proposal – such as specific products and rates – by 6 January 2020. A public hearing followed, and a final decision is imminent.

The OECD Inclusive Framework is expected to provide an update on the OECD project by the end of January 2020.

Impact on UK DST

The UK DST differs in a number of ways from the French DST and may be less susceptible to some of the challenges raised by USTR.

However, there are clear similarities and it is expected that the UK DST would at least be investigated to see if it is de facto discriminatory against US businesses.

The US Ways and Means Committee Chairman has expressed concern about a possible UK/US trade deal were a DST to be in place. Nevertheless, the Conservative Party won a majority at the December 2019 election on a manifesto that included a pledge to implement the DST.

While recent developments will need to be considered by HMT and the UK government, they do not mean that the UK will not implement and if the UK does implement then neither these developments nor the delayed release of final legislation will be seen as a reasonable excuse for non-compliance. A Budget will be delivered on 11 March 2020, leaving only a few weeks to review legislation and guidance before the tax could enter into force on 1 April 2020.

Impact on OECD project

French Finance Minister Bruno Le Maire is quoted in the press, noting that the French DST will be revoked when an OECD agreement is reached, and that there is one on the table that France can accept. However, the current proposals are incomplete and cannot be agreed by the countries involved. Much detailed work remains to be done in 2020 even if an "agreement in principle" is reached swiftly.

An ensuing trade war will impact the dynamics of the negotiations at the OECD, and may encourage an agreement; but it is unlikely to result in a swift agreement and implementation, as the scale of the project and the differences in key country positions are both significant.

Next steps for Alternative Investment Funds

- US reaction to the French DST should be taken into account in assessing the impact on relevant portfolio investments.
- More importantly the situation should be monitored as France and other territories introduce domestic DSTs.
- Any tensions in relations between the EU OECD members and the US may impact the process of agreeing proposed OECD Pillar 1 and 2 proposals.

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UK anti-hybrids rules - The continuing impact on Alternative Investment Funds and their Managers

Introduction

More than two and a half years since the UK anti-hybrid rules in PART 6A TIOPA 2010 were introduced, we are still seeing Alternative Investment Funds and their managers continue to be challenged by a lack of certainty around their application. In part, this is because the rules are still relatively new (with HMRC's view of how to apply the legislation in practice still emerging) and they have continued to evolve since their original introduction. Their relevance to Alternative Investment Fund managers is also becoming increasingly common as a result of restructuring undertaken in response to US tax reform and Brexit.

In this article we explore some areas of the rules that are continuing to present challenges to alternative investment funds and their managers.

Entities disregarded for US tax purposes – Issues from US tax reform and Brexit

Many US headed groups have made check-the-box elections to treat UK entities as disregarded for US tax purposes. In some cases, the disregarded entity has been in place many years before the anti-hybrid rules were introduced. However, more recently we have seen a number of groups make such elections in response to US tax reform, specifically in response to the BEAT rules.

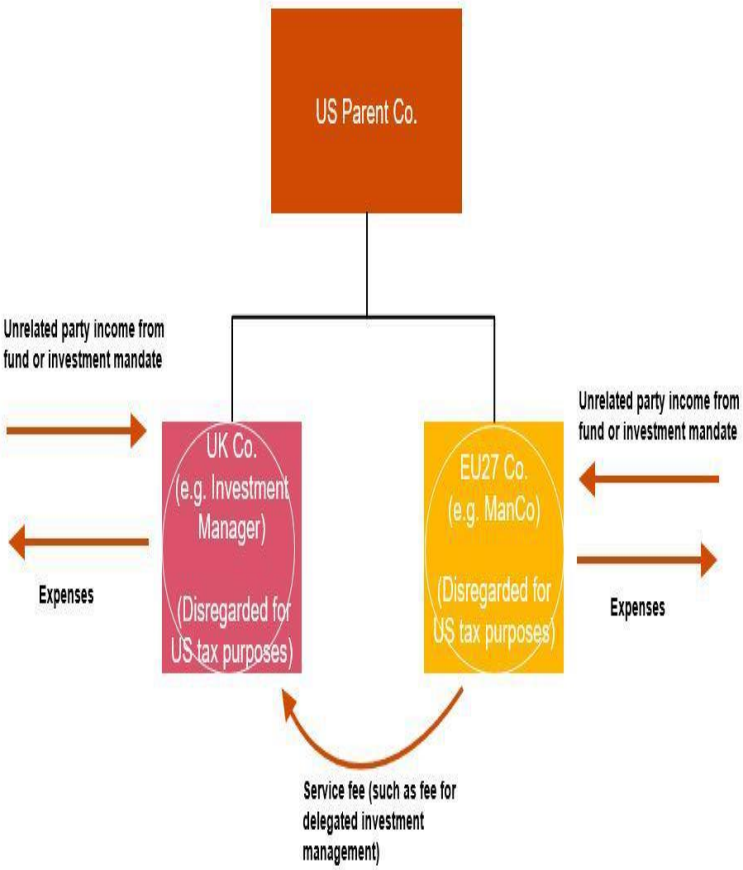
This generally results in the UK disregarded entity being deemed a hybrid entity for the purposes of the UK anti-hybrid rules. There may then be a double deduction mismatch within Chapter 9 in respect of any payments by the UK entity to third parties (however seemingly benign, such as wages and salaries, rent etc.) on the basis that they result in deductions for both UK and US tax purposes.

There may be no counteraction disallowance of the UK deductions if the UK entity has sufficient dual inclusion income (i.e. ordinary income subject to both UK corporation tax and US tax) to set its double deductions against. However, establishing what is and what is not dual inclusion income is not always easy.

The cleanest example of dual inclusion income is income earned by the UK entity directly from unrelated parties. However, in the asset management industry many UK entities earn their income from related parties. This has long been the case in respect of UK entities receiving an income stream from their foreign parents.

In addition to this, many managers operating in both the UK and the EU have undertaken restructuring to ensure they are able to continue to operate with the necessary UCITS, AIFMD and MIFID permissions post Brexit. This has resulted in new intra-group service flows (for example the delegation of investment management services from EU manager to UK entity) which may replace the UK entity's income streams which were previously received directly from the unrelated party fund or investment mandate.

Such a scenario is illustrated below. In such circumstances, careful consideration should be given to the impact of the restructuring on the UK entity's dual inclusion income under Chapter 9 of the anti-hybrid rules.



Overview

- UK Co. obtains a deduction for its third party expenses (e.g. staff costs, rent etc.).
- UK Co. earns income from EU Co. (e.g. investment management fee for delegated investment management of EU products in post-Brexit operating model).
- Intra group payment between disregarded UK Co. and disregarded EU Co. are disregarded transactions for US tax purposes.

Key questions

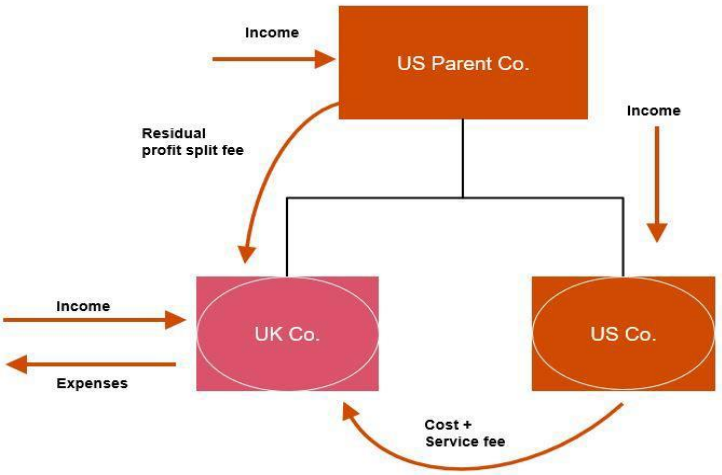
- Could a counteraction arise under the UK anti-hybrid rules?
- Does UK Co. have sufficient dual inclusion income to offset its expenses against?
- Can any of the income UK Co. earns from EU Co. constitute dual inclusion or section 259ID income?

UK anti-hybrids rules - The continuing impact on Alternative Investment Funds and their Managers (cont'd)

Entities disregarded for US tax purposes -Section 259ID

The hybrid rules were extended by Finance Act 2018 through a new section that creates, with retrospective effect from 1 January 2017, another category of deemed 'good' income referred to as 'section 259ID income'. This section 259ID income can also reduce a counteraction under Chapter 9 in a similar way to dual inclusion income.

In order for income received by the UK entity from a related party to qualify under this category, one of the conditions, Condition C, is that it must be paid to the hybrid entity by an 'investor' in direct consequence of a payment to the 'investor' by an unrelated party. Unfortunately, on plain reading, it could be too narrow to be of practical help to a number of commercial arrangements (albeit in certain circumstances a purposive interpretation may bring the provision into play). Prima facie, it does deem that the analysis could be particularly challenging in situations where the UK entity's income is transfer priced on a cost-plus basis from a related party, such as the scenario illustrated below.



Overview

- UK Co. obtains a deduction for its third party expenses (e.g. staff costs, rent etc.).
- UK Co. earns income from both its US parent Co. and its sister company (US Co.).
- Transfer pricing payments to Co. are disregarded transactions for US tax purposes.

Key questions

- Could a counteraction arise under the UK anti-hybrid rules?
- Does UK Co. have sufficient dual inclusion income to offset its expenses against?
- Can any of the income UK Co. earns from US parent Co. constitute dual inclusion or section 259ID income?

There is therefore a risk of challenge on the basis of plain reading of Condition C and its applicability to cost-plus transfer pricing methods, even where there is a genuine economic link between the activities of the UK entity and the receipt of unrelated party income by its 'investor'.

One of the key considerations is that to the extent that there is a double deduction, it will need to be determined whether the UK entity has sufficient dual inclusion income or s259ID income to avoid a disallowance counteraction.

Issues for Credit Funds

The anti-hybrid rules could potentially be interpreted to apply to restrict tax deductions for finance expenses on loans to unrelated UK borrowers, even where the only hybrid issues are within the credit fund structure. The issue could arise even where the credit fund has a minimal equity stake, or even just warrants, in the borrowing entity.

We have come across situations where the UK hybrid rules have applied to credit fund lending such that:

- UK borrowers from credit funds had to disallow interest costs on lending from the credit fund;
- The economic burden of the tax disallowance was suffered by the credit funds (through reduced exit economics on equity); and
- Credit funds lost competitive bids to debt finance deals because of the above issues.

Next steps for Alternative Investment Funds

- Depending on how other EU jurisdictions implement an EU Directive (the Anti-Tax Avoidance Directive 2) into domestic legislation, we anticipate that similar issues could also arise for Alternative Investment Funds and their Managers.
- It will therefore be important to analyse the impact of the anti-hybrid rules for both existing portfolios or when bidding for a new deal.

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Germany - MoF draft bill on the Implementation of the Anti-Tax Avoidance Directive (ATAD Implementation Act) provided to federations for comment

Introduction

On 10 December 2019, the Federal Ministry of Finance (MoF) provided various federations and associations with a draft bill on the Implementation of the Anti-Tax Avoidance Directive (ATAD Implementation Act) for comment. The decision of the Cabinet has already been scheduled for 18 December 2019.

Implementation of the European Anti-Tax Avoidance Directive

Following the adoption of EU Directive 2016/1164 of 12 July 2016 (ATAD), as amended by EU Directive 2017/952 (ATAD II) of 29 May 2017, on 10 December 2019, the MoF provided the draft implementation bill to various federations and associations for their comments.

Other EU Member States have also submitted draft bills for the implementation of the Directive in recent months, and in some cases the laws have already been passed.

The present draft bill is intended to implement the ATAD's regulations on exit taxation and hybrid structures as well as on the reform of Controlled Foreign Companies (CFC) rules. In addition, there are to be adjustments to the transfer pricing rules in Section 1 of the Foreign Taxes Act (FTA).

Exit taxation

According to Article 5 ATAD, Member States are obliged to tax (on application in instalments) undisclosed reserves in cases of cross-border transfers of assets, the relocation of businesses or the exit from a jurisdiction of a corporation. Furthermore, where assets are transferred cross-border or a corporation relocates, the “receiving” Member State is obliged to recognise the exit tax value established by the other Member State as the starting value of the assets for tax purposes insofar as this reflects the market value. The draft bill provides for the implementation of Article 5 ATAD in the Income Tax Act (ITA) and the Corporation Tax Act (CTA) (including adjustments to Sections 4, 4g and 6 ITA Draft, and Sections 36 (5) and 12 CTA Draft). Moreover, the draft bill should standardise the deferment concept as well as "bolstering" Germany’s right to tax.

The draft bill also includes adjustments and, in particular, a tightening of provisions for the exit taxation of individuals in EU cases within the framework of Section 6 FTA (Draft).

Reform of CFC rules

As part of the implementation of ATAD (Articles 7 and 8), the draft bill provides for a reform of the already existing German CFC rules. The implementation relates to Section 7 FTA et seq. The following measures should be highlighted:

- A core element is the modification of the control criterion resulting in a shift away from domestic control to a shareholder-based approach, taking into account related parties.
- In the case of multi-level company structures, loss consolidation no longer takes place at the level of the top foreign company within the framework of the CFC rules.
- In the case of profit distributions, a deduction will be introduced to avoid double taxation.

However, the draft bill does not provide for a reduction of the rate deemed to constitute a low tax rate. Thus, this remains at the 25% level. The justification given for this is that the consensus at OECD level on the introduction of a global minimum taxation should not be pre-empted.

The catalogue of active income will be retained. There are some changes as well as some tightening of certain rules (e.g. in relation to dividends and conversions).

Hybrid structures and tax residency mismatches Articles 9 and 9b ATAD oblige Member States, inter alia, to refuse the deduction of operating expenditure for certain expenses in connection with hybrid arrangements where the income corresponding to the expenses is not taxed by the creditor or these expenses can also be deducted in another state without the expenses being offset by income that is taxed in both states.

Germany - MoF draft bill on the Implementation of the Anti-Tax Avoidance Directive (ATAD Implementation Act) provided to federations for comment (cont'd)

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Hybrid structures and tax residency mismatches

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In addition, the deduction of operating expenses must also be refused in the case of so-called imported mismatches. These arise where deductible expenses and the corresponding income lead to a tax mismatch in other states which states do not eliminate this mismatch and as a consequence this mismatch is "imported" into Germany via one or more transactions.

The implementation of the rules will essentially be executed through the introduction of a new Section 4k ITA (Draft), which is supported by further provisions in the Sections 3 No. 40d Sentence 2, 50d (9) No. 3 ITA(Draft) and Section 8b (1) Sentence 3 CTA (Draft). The rules represent the ATAD minimum standard.

Further measures

Furthermore, far-reaching adjustments and in some cases a considerable toughening of arm's length principles (Sections 1, 1a, 1b FTA-Draft) and the creation of a legal basis for advanced pricing agreements (Section 89a General Tax Code -Draft) are planned.

Within those changes a proposed regulation limiting the deduction of interest expense is foreseen, if certain legally defined requirements to prove the arm's length settlement of the underlying loans are not met. The provision is applicable from 1 January 2020 onwards.

Next steps for Alternative Investment Funds

- The legislative process will be completed in the year 2020; notwithstanding this, the regulations will in principle be applicable from 1 January 2020. The Alternative Investment Fund managers should monitor developments in this area to avoid any surprises.

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