# Keeping up with Alternative Investment Funds

February 2020

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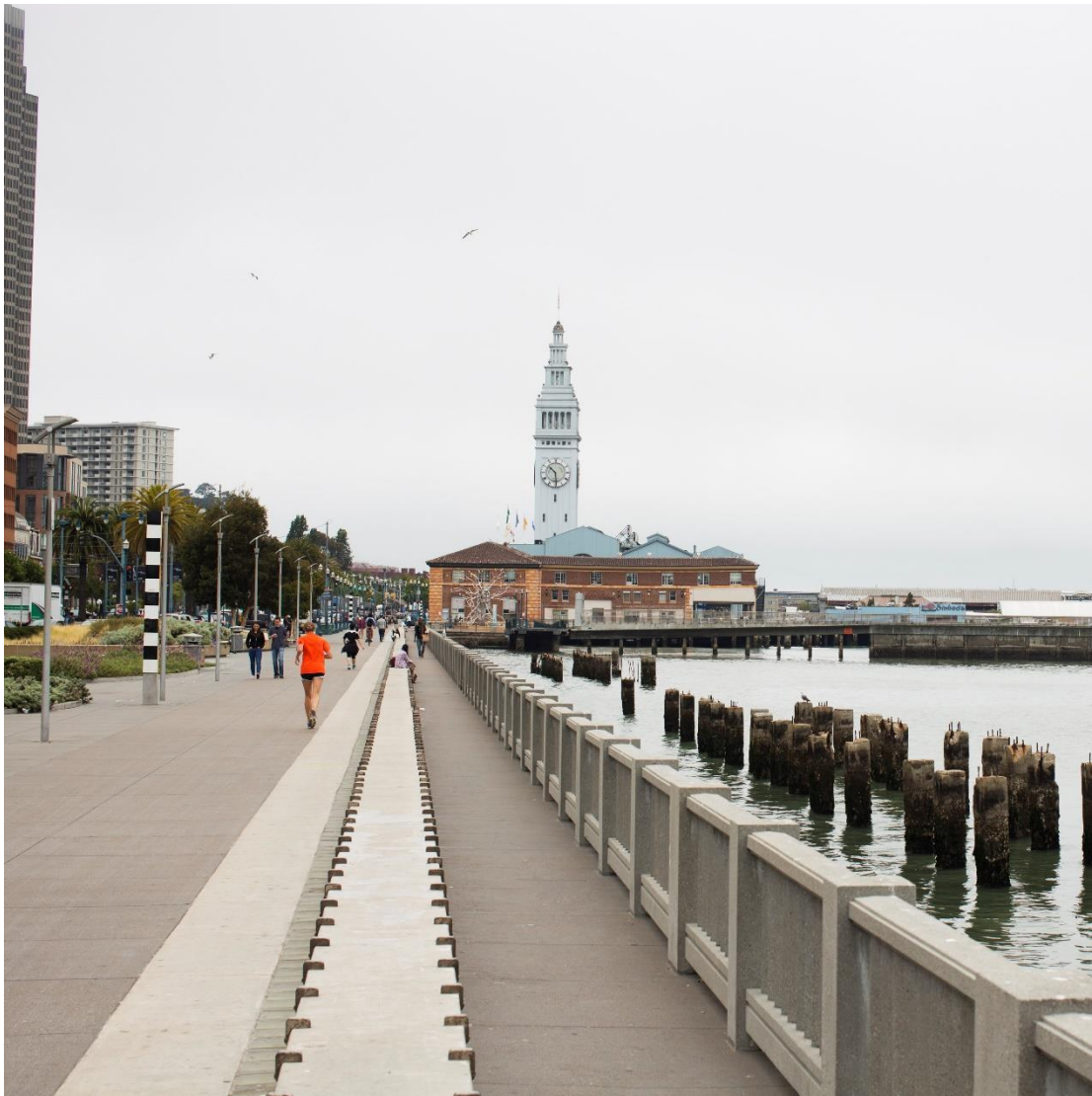

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# Introduction

## Opening blog

Welcome to our February edition of Keeping up with Alternative Investment Funds, we hope you have had a good start to the year. January was clearly historic in the UK, as we finally left the EU on 31 January.

For many Alternative Investment Funds ('AIF'), Brexit has increased costs as they now have extra management companies and funds in multiple jurisdictions to insure against Brexit risk. This cost base is going to feature as part of discussions in the industry on cost reduction and fee pressure for investment funds.

Investors are now thinking in new ways about how their capital is handled. They're embracing digital technology, are changing the way they interact with investment firms, and are increasingly interested in social responsibility and other non-financial aspects of investing. Recognising the greater level of competition in the AIF industry, they are paying attention to cost and efficiency, and even scrutinising firms' operations, and social media has given them a platform from which to broadcast their opinions, including dissatisfaction about firms that fail to meet expectations.

Tax news in January has certainly not given us a rest, and most of the recent developments have been focused on tax substance and digital tax where it seems that we're at the beginning of a fundamental transformation of the tax landscape.

In our January edition, we discussed, inter alia, the recent changes to the partnership tax return reporting, recently adopted new rules and issued guidance on UK anti-hybrids rules and an application of French Digital Service Tax.

Outside the world of tax, but certainly of great interest to the AIF industry, following the investment association paper, the Alternative Investment Management Association launched two new sound practice guides on responsible investment to help our members navigate this rapidly developing trend in investment management:

- Responsible Investment Policies for Hedge Fund Firms; and
- Policy and Practice: ESG Considerations at Alternative Investment Management Firms.

Aside from these fundamental industry changes, there is a great deal to read about on the tax side in our packed newsletter this month, where the following topics are covered:

- **Channel Island jointly issued guidance on the economic substance rules.**
- **Cayman Islands Investment Funds Private Funds Bill, 2020 and Mutual Funds (Amendment) Bill, 2020.**
- **EU Mandatory Disclosure Rules (DAC 6) – Final UK Regulations published.**
- **OECD and digitalisation.**
- **Input VAT recovery – An alternative view.**

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.

## 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.

Kind regards,

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# Channel Island jointly issued guidance on the economic substance rules

## Background

At the end of 2018 the respective parliaments of the Channel Islands (Jersey and Guernsey) approved the introduction of economic substance requirements. These requirements ensure that a jurisdiction does not facilitate offshore arrangements or structures aimed at generating profits, which are not indicative of the economic activity within the jurisdiction. The new legislation is effective for accounting periods starting on or after 1 January 2019 and applies to all companies (and not e.g. to partnerships that are CIVs as explained further below) who have tax residency in the Channel Islands. The Channel Islands released initial joint guidance in April 2019, revised in November 2019.

## The revised guidance

The revised joint guidance has been expanded to include new sections on insurance, intellectual property companies, high-risk intellectual property companies, shipping and the treatment of cell companies, which were omitted from the April 2019 version. Where your business may undertake one of the relevant activities, or operates via a cell company, we recommend these new sections are considered.

Various other sections of the guidance have been amended including the overview of the Economic Substance Requirements, (pure equity) holding companies, fund management, distribution and service centres, and direction and management.

The key changes are as follows:

- Collective Investment Vehicles ('CIV') are out of scope if they are subject to regulation in the relevant Island. However, this exclusion does not extend to subsidiaries of a regulated CIV.
- The narrative on the exchange of information, financial penalties and strike off sanctions has been expanded.
- The information required to be provided by companies carrying on relevant activities as part of the income filing process has been expanded to include the net book value of tangible assets.

A section has been included in the guidance addressing the treatment of cell companies. Protected cell companies are regarded as a single legal entity and will be required to satisfy the economic substance requirements at the whole entity level. Each cell, if conducting a relevant activity, will need to demonstrate that it conducts core income generating activities ('CIGA') in the island. In contrast, incorporated cell companies will be assessed under the rules on a cell by cell basis, with the legal entity itself only required to satisfy the economic substance requirements in relation to any activities it conducts itself.

While CIGA which generate income for the company must be undertaken in the island, isolated decisions in relation to CIGA may be taken off-island, provided that decisions take taken on-island outweigh those taken off-island, both in quantity and quality.

The definition of a (pure equity) holding company is narrow from a company with a 'primary' function of acquiring and holding equities, to a company with a 'sole' function of acquiring and holding equities.

Future legislative changes are planned that would bring self-managed corporate funds within the scope of fund management business, where the fund manager and CIV are part of the same legal entity.

Narrative changes to the Distribution and Service Centre relevant activity guidance introduce anti-avoidance comments noting that the Tax Administrations will take appropriate action where a company artificially suppresses income to avoid being subject to the substance requirements.

In respect of the directed and managed requirement, the guidance includes numerous amendments, including the confirmation that only those board meetings which are being counted towards the test to demonstrate substance need to be held on-island with a quorum physically present.

**Next steps for Alternative Investment Funds**

If business is conducted in the Channel Islands, a substance review should be implemented to establish whether the substance requirements are applicable. Once complete, the company needs to ensure that the analysis is in line with their group transfer pricing policy.

Businesses need to revisit any previous analysis based on the initial guidelines in order to ensure that the significant amendments introduced in the revised guidelines are considered, including whether any of the specific exemptions are applicable.

The island specific guidance should be referred to in order to find out more information on the IT filing process in each jurisdiction.

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# Cayman Islands Investment Funds Private Funds Bill, 2020 and Mutual Funds (Amendment) Bill, 2020

The Private Funds Bill, 2020 and the Mutual Funds (Amendment) Bill, 2020 (together the 'Bills') were published in draft form by the Cayman Islands Government on January 8, 2020. The Bills seek to strengthen investor confidence in Cayman Islands investment fund vehicles and ensure that the Cayman Islands remains a preeminent jurisdiction for investment fund formation. The Bills also seek to address EU suggestions for investment fund oversight as set forth in a report dated May 27, 2019, from the EU Code of Conduct Group (Business Taxation).

The Bills are scheduled to be tabled for consideration by the Cayman Islands Legislative Assembly on January 30, 2020 and are therefore subject to change as the Cayman Islands legislative process is concluded.

## Private Funds Bill 2020

The Private Funds Bill (the 'PFB'), 2020 establishes a framework to monitor closed-ended funds ('private funds' as defined by the PFB), set up as Cayman Islands partnerships, companies, unit trusts or limited liability companies, which are currently beyond the scope of the existing Mutual Funds Law:

- All vehicles falling within the scope of the private funds definition and section 3(1) of the PFB must i) register with the Cayman Islands Monetary Authority ('CIMA') within 21 days after its acceptance of capital commitments from investors for the purposes of investments and; ii) be registered by CIMA before it accepts capital contributions from investors in respect of investments.
- Exemptions from registration exist for certain non-fund arrangements and the PFB also includes provisions that relieve the alternative investment vehicles of registered private funds from certain provisions.
- Upon registration, private funds must file certain prescribed details with CIMA and pay an annual registration fee. There is flexibility with respect to the 'prescribed details' that must be filed.
- Registered private funds must comply with annual audit and return requirements and retain accessible records. Annual audits must be issued or undertaken by a CIMA-approved, Cayman based auditor.
- A registered private fund must also comply with certain ongoing obligations in relation to valuation of fund assets (at least annually), safekeeping of fund assets, cash monitoring and identification of securities. Flexibility as to appointing service providers, including the manager, operator or administrator, valuation, safekeeping and cash monitoring functions is permitted, provided that conflicts of interest are identified, managed, monitored and disclosed.
- The timetable for implementation is still to be confirmed and it is anticipated there will be a transitional implementation period to allow for the orderly registration of new and existing in-scope funds with CIMA.

## Mutual funds (Amendment) Bill, 2020

The mutual funds (Amendment) Bill, 2020 will enhance the regulatory and supervisory framework for open ended funds:

- Funds that previously met the fifteen or fewer investor criteria set out in section 4(4)(a) of the Mutual Funds Law (the 'MFL') will now be required to register with CIMA and once so registered will be subject to regulatory obligations.
- The exemption to the registration requirement for certain overseas private funds that solicit the Cayman Islands public for investments under the MFL will remain in place.
- All regulated mutual funds must provide CIMA with information upon registration, evidence that a majority in number of its investors are capable of appointing or removing the operator of the fund, pay an annual registration fee, comply with annual return requirements, retain accessible records and have annual audits issued or undertaken by a CIMA-approved Cayman based auditor in accordance with IFRS or prescribed GAAP's.
- Existing Section 4(4) Mutual Funds have six months from the Bill passing into law to register with CIMA and to comply with the new requirements.

## Penalties

Operators (e.g. managers, trustees or directors) of Mutual or Private Funds not complying with these new rules and carrying on/attempting to carry on business may be subject to a fine of $100,000.

**Next steps for Alternative Investment Funds**

Consider whether existing or planned Cayman funds meet definitions of a Private Fund or a Mutual Fund. Existing Private Funds should monitor the transitional arrangements announced and register appropriately during transitional period. Existing Section 4(4) Mutual Funds should begin to prepare meet the relevant conditions over the next 6 months.

All Alternative Investment Funds with Cayman entities in their fund group or management group structures should continue to monitor the Cayman Economic Substance requirements, with Guidance 3.0 still due to be circulated by the Cayman Islands Tax Information Authority.

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# EU Mandatory Disclosure Rules (DAC 6) – Final UK Regulations published

On 13 January 2020, final regulations to implement EU Directive 2018/822 (also known as DAC6) on the mandatory disclosure and exchange of cross-border arrangements were laid before Parliament and have become law.

The rules are very important for Alternatives Investment Funds who themselves may be intermediaries with reporting obligations. Alternatives managers and their Funds have a high volume of transactions and potentially reportable arrangements which regularly may include many jurisdictions and many intermediaries.

The International Tax Enforcement (Disclosable Arrangements) Regulations 2020 (SI 2020 No.25) follow DAC6 closely and require disclosure to HMRC of cross-border arrangements entered into by taxpayers, which fall within certain hallmarks. The final regulations incorporate a number of changes made following consultation on the draft regulations, which were published last year. HMRC has also published a summary of responses to that consultation, and following further consultation, it will publish final guidance before the regulations come into force in July 2020.

As the UK has left the EU on 31 January 2020, under the transitional arrangement provided for in the Withdrawal Agreement, these rules will continue to apply at least until the future economic partnership between the UK and the EU is determined. This will be determined by 31 December 2020.

By way of a reminder, the regime has been 'live' since June 2018, although we are in a transitional period with the first reporting for the period from June 2018 to July 2020 due in August 2020. The obligation to disclose to HMRC falls on UK intermediaries (unless or to the extent to which legal professional privilege applies). Where there are no UK intermediaries with a reporting obligation, the obligation to disclose may fall to UK taxpayers. There are penalties for non-compliance with the rules.

Following consultation, the final regulations include a number of changes to more clearly define the scope of the rules and the obligations of those who are required to disclose arrangements to HMRC. HMRC is developing guidance to clarify when and how the rules apply and this will be published in HMRC's International Exchange of Information Manual.

It's important to note that some of the key aspects of the draft regulations have been retained. In particular, the limitation of tax advantage to one not consistent with the principles and policy objectives of the relevant tax law, should ensure that those hallmarks subject to main benefit test are more targeted.

### Differences between the final regulations and the draft regulations which were published on 22 July 2019 include:

- Amendments to the penalty regime – normally penalties will be limited to £5,000.
- Limiting 'tax advantage' for the purposes of the main benefit test to (broadly) EU direct taxes.
- Ensuring that an intermediary does not have an obligation to report in multiple jurisdictions.
- Restricting reporting obligations to intermediaries and relevant taxpayers with a UK connection.

### Matters to be addressed in guidance

Particular areas of concern that will be addressed in guidance include:

- Definition of cross-border arrangement – when does an arrangement 'concern' more than one jurisdiction.
- Who is an intermediary, and what is expected of intermediaries in different situations.
- Clarification of reporting triggers (for example, when an arrangement is 'made available').
- How the hallmarks apply to partnerships and other transparent entities.
- Application of the rules to those subject to legal professional privilege ('LPP').
- Scenarios where taxpayers and intermediaries should not face penalties for late reports.
- Clarification of interpretation and examples on the application the hallmarks main benefit test (including guidance on the scope of the 'substantially standardised' documentation hallmark (A3) application C(1) hallmarks to deductible cross border payments).

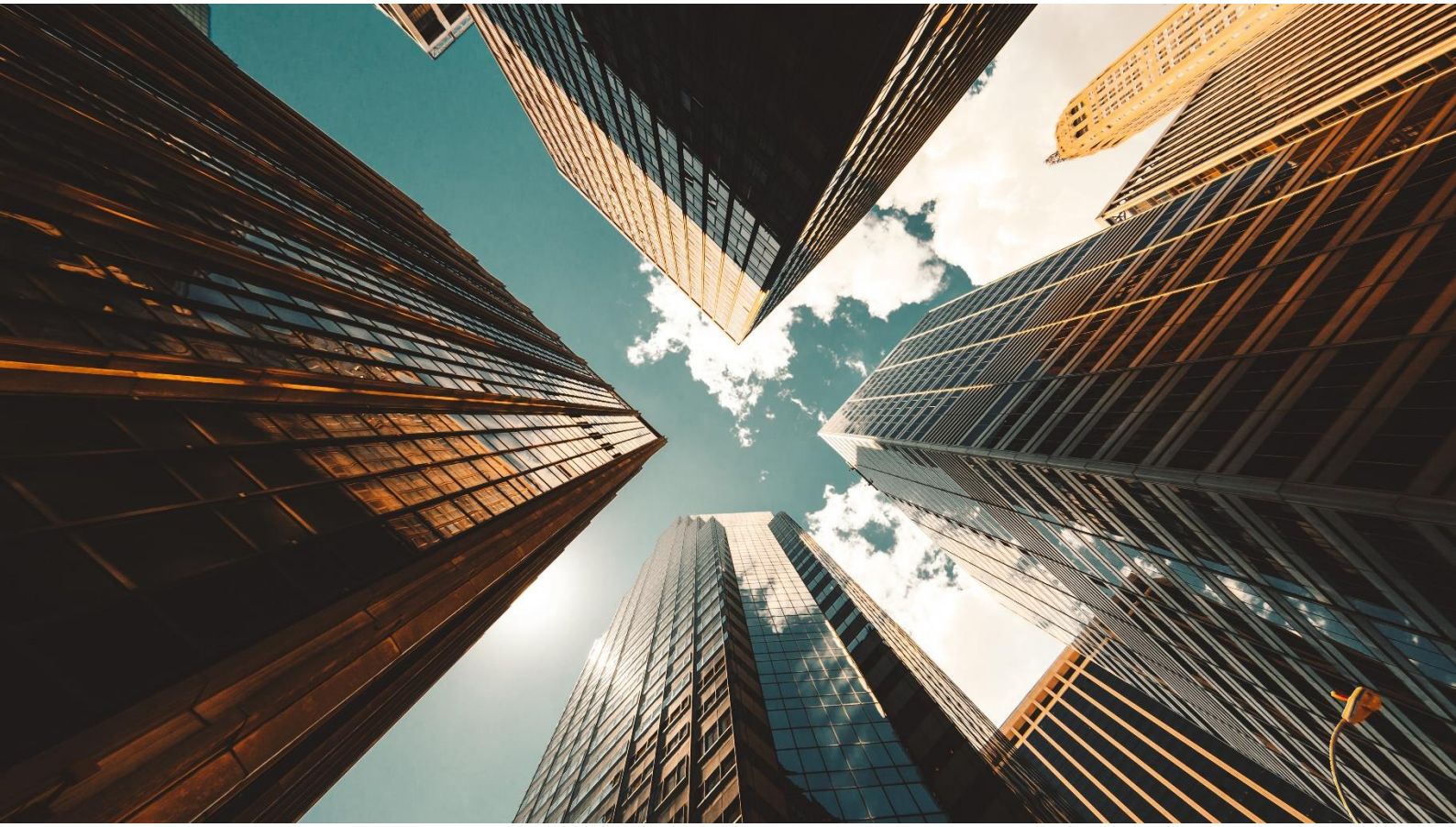
# EU Mandatory Disclosure Rules (DAC 6) – Final UK Regulations published (cont'd)

There is not long to go before the regulations apply from 1 July 2020, so businesses need to understand their obligations and ensure that they have the systems and processes in place to comply. From an asset's management perspective, there are still a number of technical areas that remain unclear, However, our thinking is well advanced and we are continuing to liaise with HMRC on the industry issues.

We are also seeing clear trends emerging on implementation preparation. This includes Alternatives Investment Funds clients first conducting an Impact Assessment on how the technical aspects of the legislation across each asset class and deal type, the level of analysis needed over transactions and structures, and determining the intermediary responsible for any reporting.

Operational readiness for compliance is also important as many Alternatives Investment Funds have diverse structures, limited direct tax involvement in day to day deal team operations and a high volume of high value and complex transactions. We are seeing Alternatives Investment Funds managers considering areas such as training for Deals and Ops teams, putting in place central Tax oversight processes, and considering the role technology may play in ongoing analysis and reporting.

We have a team of DAC6 technical and operational specialists currently working with a number of organisations in the Alternatives sector. We would be happy to set up some time for a discussion with them on how you're approaching implementation and to share their market insights. For further information speak to your usual PwC contact or one of our specialists.



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# OECD and digitalisation

## In brief

In May 2019 the OECD published a work plan relating to the international tax framework and how it should be adapted in response to the digitalisation of the economy, with more detailed proposals released in October and November 2019. These proposals will change the international tax landscape in a fundamental way and are expected to impact all large international businesses, not just those that are highly digitalised.

The momentum behind these proposals has been building with increasing changes to the political environment bringing this into focus on a global scale. The work plan is comprised of two Pillars: **Pillar 1**, which aims to introduce a new 'tax nexus' and allocation of residual profits to user/market jurisdictions including in the absence of a physical presence, and **Pillar 2**, which seeks to establish a global minimum tax framework.

At the end of 2019 the OECD held public consultations on both Pillar 1 and Pillar 2 and received an unprecedented amount of written responses. The OECD are intending to reach agreement amongst the members of the Inclusive Framework on the underlying principles of the proposed changes by early 2020 and to complete the project by the summer of 2020; we expect further clarity from them in the near future. The remainder of this article seeks to provide a recap of the 2019 work, and the areas of potential impact for the alternative asset management industry.

## Pillar 1

On 9 October, the OECD released a public consultation document setting out an OECD Secretariat Proposal for a 'Unified Approach' under Pillar 1, which aims to introduce a new 'tax nexus' granting countries taxing rights over the value derived by a business' activity or participation in user/market jurisdictions[1]. The market jurisdiction is taken to be the jurisdiction where the 'end user' or ultimate consumer is located.

It is important to note that the OECD is yet to clarify exactly which businesses are intended to be within the scope of the proposals, and we expect more clarity on this in the near future. The extractive industries are explicitly referenced as 'assumed to be out of scope' and further work is being undertaken to ascertain whether any additional carve-outs or exclusions, including for the financial services sector, will apply. As part of the public consultation process in November 2019, the OECD **received written responses** from various multinational groups and industry associations, including the BVCA, European Fund and Asset Management Association, SIFMA, AIMA, Investment Company Institute and The Investment Association, providing their input and articulating why they feel the proposals should not apply to the asset management industry as part of a financial services industry carve-out[2]. PwC's response to the proposals can be found **here**[3].

As a recap, the Pillar 1 proposal document considers the approaches available to determine the amount of profits that would be subject to new taxing rules in the market jurisdiction and proposes the following three tier mechanism:

- **Amount A** is a new formulaic allocation of a portion of deemed global residual profit (in excess of an agreed baseline and based on global consolidated group financial statements), among countries where customers are located, regardless of where the business's physical activities are located.
- **Amount B** envisages creating a fixed percentage return that would be allocated to some 'routine' functions (specifically, marketing and distribution) which would remain taxable according to the existing transfer pricing rules. For the asset management sector, this fixed % return to marketing and distribution activity may apply to capital raising and investor relations functions, and the interaction with and impact on current transfer pricing models would need to be carefully analysed.
- **Amount C** would apply where the business' activities in a country are deemed greater than the 'routine' functions compensated by Amount B. In this case, a country could seek to assess non-routine amounts if warranted under traditional transfer pricing facts and circumstances tests, much like the existing transfer pricing system works today.

The outcome of the above is that a portion of these deemed residual profits will be reallocated to jurisdictions based on the current transfer pricing rules (i.e. on current value drivers), but a portion of the remainder will now be used to remunerate the market jurisdictions from which the business derives a part of its value.

The specific impact of the Pillar 1 proposal for the Alternative Investment Funds sector is yet to be seen if they are considered to be within scope, although at present we expect the impact will differ depending on the types of investors targeted, i.e. institutional investors, retail investors or high-net-worth individuals (HNWIs). The current scope of the Pillar 1 proposal is large, consumer facing businesses, rather than wholesale businesses. Critical points for the alternative asset management sector are therefore: how the term 'consumer' will be defined (i.e. whether this will capture HNWIs); and potentially how segmentation or bifurcation of business lines will be achieved.

[1] https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf

[2] https://www.oecd.org/tax/beps/public-comments-received-on-the-secretariat-proposal-for-a-unified-approach-under-pillar-one.htm

[3] https://www.pwc.com/us/en/tax-services/publications/insights/assets/OECD-Pillar-1-Paper-PwC-Response-Final.pdf

# OECD and digitalisation (cont'd)

A working assumption is that the term 'consumer' is intended to capture individuals who use services for personal purposes (i.e. outside the scope of a professional or business activity), meaning alternative investment fund managers who target only institutional investors could potentially be outside the scope of the Pillar 1 proposal. If part of the alternative investor base is captured by the term 'consumer', there is potentially a further question around the availability and accessibility of information in relation to the end investors in cases where, for example, third party placement agents are used. Finally, definition of 'consumer' will also be important in assessing the potential impact of the Pillar I proposal on the underlying investment portfolio of the fund.

## Pillar 2

The OECD published its international tax consultation relating to Pillar 2 of the work plan on 8 November[4]. Pillar 2 seeks to address the remaining risk of 'profit shifting' to jurisdictions with no or low levels of taxation, where the risk is not deemed to have been satisfactorily addressed by the BEPS project. As part of the public consultation process, OECD received written responses from various multinational groups and associations[5]. PwC's response to the proposals can be found **here**[6].

The Pillar 2 proposal seeks to put in place globally agreed income inclusion rules, which would apply 'top up' taxes at the shareholder level and could significantly increase tax cost and complexity. In addition, denial of tax deductions and treaty benefits are being considered with the aim of ensuring minimum levels of tax are paid on all income globally. There remain a number of unknowns that make the impact of Pillar 2 difficult to assess. For example, whether the minimum tax would be calculated on a group, jurisdictional or entity level; how the 'minimum level' tax rate might be calculated or determined; and how the new rules might interact with existing domestic rules (e.g. would the UK CFC rules be redundant or would they still be used).

In addition, the proposal document leaves certain operational questions unanswered, including what the starting point would be for any calculations (local, jurisdictional or consolidated accounts) and how the assessment methodology would incorporate differences in accounting standards, timing differences and tax bases. Similar to Pillar 1, the possibility of carve outs, either on the basis of industry, industry-wide carve-outs may be less likely given the objectives of Pillar 2. Notwithstanding this, the Alternative Investment Funds industry has lobbied for an exemption for investment vehicles for a number of reasons. Importantly, the objective of the Pillar 2 proposals is to ensure that the 'profits of internationally operating businesses' are subject to a minimum tax, and investment vehicles are not 'businesses'. Furthermore, it is generally accepted that investment vehicles are not subject to tax, as investing via an investment vehicle should not give rise to a worse position for investors than direct investment.

The current expectation is that for businesses primarily operating in high-tax jurisdictions, the impact of Pillar 2 will largely be additional compliance complexity. However, for businesses with operations in low or zero tax jurisdictions there may be a significant tax cost. If there is no exemption for investment vehicles, assessing the impact for investment structures will be critical.

## Key takeaways[7]

At present there is no indication of whether a financial services carve out will be incorporated into the Pillar 1 and/or Pillar 2 proposals. In the absence of a financial services carve under Pillar 1, Alternative Investment Funds targeting retail investors and potentially HNWIs are likely to be most impacted, due to the OECD's focus on consumer facing businesses. The changes would likely result in an increase taxable profit market jurisdictions (although significant increase in the overall effective tax rate), allocation of residual profit, where previously they might only have earned a routine return local activity (if any) undertaken from these locations. Regarding Pillar 2, no particular sector is likely impacted another impact will be driven by the specific global footprint of the business.

As we are expecting further guidance from the OECD imminently, businesses should continue to communicate with key stakeholders as early as possible, highlighting commercial impact on the business and future implications the group; both at the level of the management group and the fund investment structures. Consideration should given to the necessary compliance and system requirements to ensure any associated compliance burden can be borne, if necessary.

[4] https://www.oecd.org/tax/beps/public-consultation-document-global-anti-base-erosion-proposal-pillar-two.pdf.pdf

[5] https://www.oecd.org/tax/beps/public-comments-received-on-the-global-anti-base-erosion-globe-proposal-under-pillar-two.htm

[6] https://www.pwc.com/gx/en/tax/pdf/oecd-pillar-2-paper-pwc-response-december-2019.pdf

[7] https://www.pwc.com/gx/en/services/tax/publications/fs-organisation-ready-for-change-international-tax-framework.htm

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# Input VAT recovery – An alternative view

The extent to which financial services businesses can recover input VAT has become an increasingly complex area, and one which is subject to close scrutiny by HMRC. Given the requirements of the Senior Accounting Officer process and the HMRC penalty regime, it is vital that those responsible for VAT are fully conversant with input VAT recovery rules, understand the associated risks of errors, and are up to date with developments in these areas. Businesses need to remain compliant both in the UK and elsewhere.

This article looks into some of the challenges, and how it applies to Alternative Investment Funds, in more detail. It also considers forthcoming VAT changes announced by HMRC that will impact the investment management of certain alternative funds.

The CJEU opinion in The Chancellor, Masters and Scholars of the University of Cambridge ('UoC'), and the First Tier Tribunal ('FTT') in Melford Capital General Partner Limited ('Melford Capital') have brought new challenges and potential opportunities to VAT recovery.

In UoC, the CJEU reaffirmed that transactions deemed to be non-business do not in principle give rise to a right to deduct input VAT. The investment activity undertaken by the University when investing donations and endowments was viewed as being akin to that of a private investor, and therefore non-economic, and did not entitle recovery of input VAT. Although the income from investments reduced the price of the UoC's taxable and exempt supplies, the CJEU considered that the investment costs were not factored into UoC's supplies. As such, the CJEU rejected the possibility that those costs could be viewed as overheads of the taxpayer, and therefore any associated VAT non-recoverable.

HMRC has welcomed this decision and may seek to apply it broadly. As such, we recommend that taxpayers with an investment function review this activity to assess whether or not there are activities that could be viewed as non-economic, particularly where VAT recovery has been made. This question is complex, and businesses need to understand the precise detail of the investment activity undertaken, the purpose of such activity and how associated VAT has been treated.

By way of contrast, and perhaps surprisingly, the decision by the FTT in the case of Melford Capital is directly at odds with HMRC's stated policy on input tax recovery for private equity businesses with onshore UK funds.

Melford Capital is a member of a VAT group, along with an LLP. Melford Capital is the General Partner ('GP') of a Limited Partnership ('Fund'), which also formed part of the VAT group by virtue of GP's VAT group status. Melford Capital incurred costs in relation to setting up and operating Special Purpose Vehicles ('SPV's') that are members of a separate VAT group. The SPVs are provided management and advisory services by the LLP, which are subject to VAT. However, the VAT group also received dividends and liquidation proceeds from the SPVs' investments. Such transactions are not considered supplies for VAT purposes.

It has generally been accepted that the mere acquisition of shares and receipt of dividend income does not of itself constitute economic activity. As such, 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 transactions. However, HMRC will typically require an input tax restriction in relation to the fund investment activity, which can often involve the application of a relatively complex input tax recovery calculation, the basis of which may also need to be agreed with HMRC.

Melford Capital argued though that its 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). Despite the VAT group receiving two streams of revenue (e.g. taxable management services and the receipt of dividends/liquidation proceeds), Melford Capital contended that the non-economic activities (e.g. the receipt of dividends/liquidation proceeds) should be disregarded from any apportionment calculation. The FTT agreed with this analysis and found in favour of Melford Capital, which, in principle, allowed to recover VAT in full, were no exempt activities undertaken by the VAT group.

These cases illustrate some of the challenges faced by tax departments and finance functions in reaching decisions on what, if any, input VAT can be recovered. Unfortunately, there are an ever-growing number of areas where the precise level of allowable input VAT recovery is far from certain. It is therefore important for Alternative Investment Funds to review their activities to identify any instances where the recovery of input VAT may be considered doubtful, and to seek appropriate advice, where necessary.

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# Input VAT recovery – An alternative view (cont'd)

### Investment management changes on 1 April 2020

HMRC have announced VAT changes which give effect to the CJEU decisions in ATP and Fiscale Eenheid X. On 1 April 2020, it is proposed that the 'management' VAT exemption will be expanded, on a legislative footing, to include management services supplied to Defined Contribution ('DC') Pension Funds and Closed Ended funds that invest in assets other than equities (such as REITs).

Whilst the change in VAT liability of the management of DC Pension Funds has been largely adopted by the industry, and perhaps more relevant to 'mainstream' Asset Managers, the change impacting REITs and other such funds will need to be implemented as of 1 April 2020 and affected businesses will need to ensure appropriate customer communications are made and the relevant accounting system changes applied to give effect to these changes from that date.

### PwC's VAT breakfast events

The VAT complexities and uncertainties faced by both Alternative and Mainstream Fund Funds and their Managers form the focus of PwC's Asset and Wealth Management VAT breakfast events. The next event take place on 24th March 2020 at our More London, London office. There is no charge for attendees joining these events.

Should you, or a colleague, wish to attend this event or obtain more information, please consult with your regular PwC contacts, or email Mandi Dunbar at mandi.dunbar@pwc.com to request attendance. We look forward to seeing you.

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