Keeping up with Alternative Investment Funds

April 2020

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Introduction

Welcome to our April edition of Keeping up with Alternative Investment Funds. Recent times have certainly been unprecedented and challenging for all of us and although our overriding concern continues to be the safety and wellbeing of everyone as we adjust to the new ways of working, Fund Managers, like other businesses, will, if not already, be trying to understand how the current restrictions on movement impact their operations and their international tax position and how they can best mitigate any business risks which arise directly or indirectly as a result of the outbreak.

We recognise that navigating through the vast number of measures introduced, not only by the UK but other countries, can be a massive challenge in itself so we developed a dedicated firmwide **Covid-19 website** where you can find the latest updates on any key concerns you may have. As you may be aware, we also ran a live webcast in March on Covid-19 where a panel of advisors discussed which areas should be considered as part of any Covid-19 planning and response strategies. If you were unable to attend or would like to go over anything again, you can view a recording of the webcast **here**.

Amongst many Covid-19 related matters, we believe that permanent establishment risk from a corporate tax, payroll and social security perspective, and tax residency risk from a personal tax perspective and the reliefs being introduced by different jurisdictions will need to be monitored and understood to ensure that Fund Managers and, in fact, any other businesses, can make effective and targeted operational decisions over the coming months. With this in mind, we created a **tool** on our website where you can get the latest updates on the measures being introduced by any jurisdiction across all areas of tax so that you can keep up to date with the developments not only in the UK but in any other country that is affected by Covid-19. Equally, it will be important for Fund Managers to make sure that they are not carrying out regulated activities in jurisdictions where they do not have a regulatory licence.

Following great success of our Alternative Investment Funds Conference back in February we decided to hold fortnightly Alternative Investment Funds Virtual Client Roundtables to ensure that we all keep up to date with any developments and provide a platform for our clients to connect and ask any questions they may have, not only on the topics covered in the session, but on anything that may concern them.

We held our first session on 25 March and the next two sessions on 8 April and 22 April, thank you to all of those who attended and participated. Over the last three sessions we covered a wide range of topics which included:

- Covid-19 update
    - UK Government support and tax cash flows
    - Tax residency/Permanent Establishment risk
    - Personal tax implications of displaced employees
    - Legal /corporate secretarial implications
    - VAT implications
    - US update on Coronavirus Aid, Relief and Economic Security Act
    - Luxembourg perspective
    - Reconsideration of capital structure of portfolio companies
- Luxembourg deductibility of interest and royalty expenses incurred with associated entities in EU blacklisted countries
- EU Mandatory Disclosure Regime update
- HMRC consultation on UK Asset Holding Companies in alternative fund structures

The next Virtual Client Roundtable will be held on Wednesday 6 May where we will be joined by Gavin Barwell, PwC senior advisor and former Chief of Staff to Theresa May who will take us through the possible Covid-19 lockdown exit strategy and long term implications. Please share any feedback on the Virtual Roundtable sessions or suggestion for topics with richard.madden@pwc.com.

In the meantime, we have packed our newsletter with the articles mainly covering the March Budget announcements and include the following:

- UK – Asset Holding Companies consultation
- UK – Hybrids and other mismatches consultation paper
- UK – Finance bill and HMRC technical notes/consultation papers
- UK – HMRC's post-Brexit plans for non-UK funds
- Italy – No access to domestic tax exemptions for transparent funds
- EU and UK – A round of VAT updates
- UK – Draft HMRC Guidance for EU Mandatory Disclosure Rules (DAC 6)

Please do continue to reach out to your usual PwC contacts if you would like to discuss any of the above, and please do share your feedback with us if there is a particular topic or issue you would like us to cover.

Kind regards,

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UK Asset Holding Companies Consultation

Background

During the Government's budget on 11 March 2020, the intention was announced to review the UK funds regime, with a particular focus on the level of attractiveness of the UK for entities through which alternative funds hold assets, and what reforms could enhance the UK's competitiveness in this area.

In this regard, HMRC released a consultation document and have invited formal responses to this in relation to the tax treatment of asset holding companies in alternative fund structures within the UK.

This consultation is welcomed by PwC as an opportunity to provide our thoughts on the barriers to the UK as a holding location for alternative funds and suggest potential adjustments that could be made to improve this going forward. The consultation is also an opportunity to improve the government's understanding of intermediate Asset Holding Companies ("AHCs"), including:

- The fund structures in which they are commonly used
- Commercial drivers of their location
- Fiscal and economic benefits they bring to the jurisdiction in which they are located

Responses will be required to be submitted to HMRC by 19 May 2020 for consideration.

Specific queries raised by HMRC

The consultation specifically focuses on nine questions, as follows:

Q1. What role do AHCs perform within alternative fund structures? What are the commercial and tax benefits of using AHCs within alternative fund structures, and what advantages do they offer versus direct investment?

Q2. To what extent are AHCs prevalent in other funds or pooled investment structures?

Q3. What do you consider to be the main fiscal and economic benefits to the UK - both direct and direct - of greater domicile? Can you support this with any quantitative evidence?

Q4. For each of the fund classes (Credit, Real Estate and Private Equity) what are the different challenges that the UK tax rules create for the establishment of AHCs in the UK? Are there any other fund classes for which similar challenges arise?

Q5. How are the challenges to locating an AHC in the UK, to the extent they exist, currently overcome? How do the tax rules in other countries address these challenges?

Q6. What impacts have recent developments in the international tax landscape had on determining where to locate an AHC? How have asset management firms so far responded to these developments?

Q7. To what extent are there non-tax barriers to AHCs being located in the UK? If so, how might these dilute the impact of reform to existing tax rules intended to improve the UK's attractiveness as an AHC location?

Q8. How could the challenges identified in Q4 best be overcome?

Q9. Do you consider that there is a case for the government to develop specific rules concerning the tax treatment of asset holding vehicles in alternative fund structures? What could those rules look like? How should eligibility be defined for qualifying fund structures and the AHCs within them?

PwC Response

We are currently collating a network wide response to be submitted to HMRC in relation to the above noted questions.

One area that we would very much expect to raise in our response will be the requirement to consider other aspects outside of Corporate Tax itself, that impact the decisions being made around using the UK as an AHC jurisdiction - these include considerations on substance, personal tax and regulation.

Other points we understand the consultation is looking to focus on include:

● Credit Funds: whether modifications to the eligibility criteria for the UK's Taxation of Securitisation Company Regulations could allow asset-holding companies within credit funds to benefit from the securitisation tax regime in the UK making the UK a more viable location for such entities.

UK Asset Holding Companies Consultation

● Real Estate Funds: the government acknowledges that the Substantial Shareholding Exemption remains of little benefit to asset-holding companies within real-estate funds that have a mixed investor profile of tax-exempt qualifying institutional investors ('QII') and non-exempt investors and is seeking to understand how further reforms could make the UK a more attractive location for these structures in a real-estate context, such as:

○ an expansion of the QII rules;

○ the creation of a more comprehensive participation exemption by removing the trading conditions at investee level;

○ Options for addressing the treatment of rental income flows through a UK holding structure;

○ expanding the REIT regime by broadening its availability to a wider class of UK property holding companies.

● Private Equity Funds - the Government wants to understand what barriers remain to private equity structures utilising UK asset holding vehicles and whether these barriers exist in other jurisdictions. In particular, the Government notes the difficulty in retaining the character of capital gains realised by UK investment vehicles on the disposal of shares in portfolio companies when investment returns are returned to the fund and would like to understand the impact in other jurisdictions and whether this is unique to private equity structures or relevant to other asset classes.

● Whether the reliance on exemptions to access double tax relief on corporate interest withholding tax imposes a barrier on the UK's attractiveness as a location for these structures

● The way in which VAT rules apply to funds and holding entities, to consider how VAT is applicable to fund management fees. As VAT can present a significant cost for UK funds and holding vehicles, considering how the VAT rules should apply going forward will be an important component of the overall consideration of the competitiveness of UK funds and intermediate entities.

Conclusion

The asset holding companies consultation is a great opportunity to provide feedback to the Government on the current UK environment for holding companies and suggest enhancements which would increase the attractiveness of the UK as a base location for both holding companies and funds.

We would very much welcome any thoughts and comments you may have on the consultation.

Next steps for Alternative Investment Funds

The consultation is a great opportunity to provide feedback to the Government on the current system and to suggest enhancements which would increase the attractiveness of the UK as a base location for both holding companies and funds.

Funds managers should consider the detail provided in the consultation and make representations on the specific points raised, or any others about which they have concerns, directly to HMRC or through industry bodies such as the BVCA.

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UK - Hybrid and other mismatches consultation paper

HMRC released a consultation paper on 19 March 2020 in order to gather evidence and views in relation to three elements of the hybrid mismatch legislation at Part 6A TIOPA 2010. The consultation period runs to 29 May 2020.

Double deduction rules – Section 259ID

This will be of particular interest to US headed groups with UK entities that have made 'check-the-box' elections to be treated as disregarded for US tax purposes. HMRC has acknowledged that many taxpayers have concerns regarding the narrow interpretation of 'investor' and 'in direct consequence in section 259ID. In particular for Alternative Investment Fund structures, third party income often arises to entities in the group other than the investor, meaning that the conditions of section 259ID may not be met. HMRC is receptive to exploring the case for change in this area and would like to obtain evidence of which structures are most impacted, the barriers to restructuring these structures, and the extent to which the issue is mitigated by foreign tax credits.

Acting together definition – Section 259ND(7)

The acting together rules are designed to prevent otherwise unconnected parties from working together or being used to circumvent the impact of the hybrid rules. HMRC acknowledges that this section is drafted broadly such that parties between whom there is no contractual relationship may be taken to be acting together. The consultation paper identifies two specific scenarios where this may be the case:

a) Loans subject to inter-creditor agreements or including group-wide behavioural covenants; and

b) Parent company guarantees fettering to some extent the parent's usual discretion to direct its subsidiary's actions.

HMRC accepts that in neither of these scenarios would there generally be a level of control of the payer by its counterparty, akin to group membership, that should be taken to give rise to acting together. Accordingly, HMRC would like to gather views on arrangements where it is believed that section 259ND applies disproportionately and seek guidance on modifications to address these concerns.

Exempt investors in hybrid entities

HMRC is willing to consider amending the rules to provide an exemption from counteractions that arise where the hybrid rules attribute the non-taxability of the receipt of a payment to the presence of a hybrid entity even if the investor could have received a payment directly and not been subject to tax. HMRC has identified the following potential solutions, and is receptive to view on these and other proposals:

- A 'white list' of entities which would be accepted as qualifying to prevent counteractions;
- A blanket exemption from counteraction for entities which would not be subject to tax on a direct payment, couples with a 'black list' of entity types which would not qualify for the exemption; or
- A principles-based definition of the characteristics of an entity that would qualify as not giving rise to counteractions

Next steps for Alternative Investment Funds

The consultation is helpful in outlining a number of areas of the hybrid mismatch legislation which HMRC is revisiting to ensure they do not capture scenarios not intended to be within the scope of the rules.

Fund managers should consider the detail provided in the consultation and make representations on the specific points raised, or any others about which they have concerns, directly to HMRC or through industry bodies such as the BVCA.

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UK - Finance bill and HMRC technical notes/consultation papers

Following the Spring 2020 Budget on 11 March, on 19 March the Government published the Finance Bill and HMRC published further technical notes and consultation papers. This article contains a summary of the technical notes and consultation papers most relevant to Fund managers, as well as the key legislative clarifications included in the Finance Bill.

Finance Bill

Digital services tax

The Finance Bill and guidance released by HMRC provided some further details regarding the implementation of the UK Digital Services Tax ('DST'). The scope remains very different to other DSTs seen in Europe. Rather than seeking to tax specific revenue streams, the UK DST seeks to identify in-scope activities globally, attribute deemed revenues to them, and then tax the portions that arise "in connection with" interactions with UK users. Only groups with £500 million global in scope revenues will be liable, and the first £25 million of UK in-scope revenues is not taxable.

Crucially, in relation to the Online Financial Marketplace exclusion from the DST, there have been some changes from the previously published draft legislation. The requirement to be trading in financial instruments has been expanded to include the trading of financial instruments, commodities or foreign exchange. However, it is worth noting that trading in crypto currency assets is still expected to be excluded from the exemption (i.e.. it is expected to be within the scope of the UK DST).

Additionally, UK users will be considered to be those resident in the UK, unlike most other DSTs which look to IP addresses or geolocation. Accordingly, it is not possible for businesses to take comfort on their UK DST position from work done for other countries' DSTs. However, noting the currently defined in scope activities of social media platforms, search engines and online marketplaces, it is not expected that a large portion of Fund managers will be impacted by the UK DST.

HMRC technical notes/consultations

Reduction in the lifetime limit for Entrepreneurs' Relief

Following the announcement in the Budget that the amount of lifetime gains that qualify for Entrepreneurs' Relief will reduce from £10 million to £1 million, the Government released a providing further details. The technical note explains technical note how the new rules counter "forestalling arrangements", such as unconditional contracts entered into before Budget day or contractual completion of the disposal after Budget day.

In addition, special rules will apply when shareholders in a company make an election under section 169Q of TCGA 1992 following share reorganisations or share exchanges. In these cases, the new lifetime limit will apply to gains that result from the making of the election.

Taxation impacts arising from the withdrawal of LIBOR

HMRC has published some draft guidance setting out its view of the potential tax issues which might arise as a result of the withdrawal of LIBOR and aims to provide some clarity for those amending financial instruments which refer to LIBOR. It clarifies that, where parties agree to change the terms of an instrument in response to the withdrawal of LIBOR, HMRC would normally view this as a variation of the existing instrument, and as such the amended contract should be regarded as the same contract and entered into at the same time as the original one. HMRC has identified the following provisions.

- **The Disregard Regulations:** If references to LIBOR in a hedging instrument are amended at a different time to references to LIBOR in the hedged item, or they are replaced with different rates, the Disregard Regulations can still apply provided the intention to hedge remains.
- **Grandfathering:** Where a financial instrument benefits from a grandfathered treatment, HMRC would normally expect this treatment to continue where amendments are made in response to benchmark reform.
- **Double taxation treaty passport scheme**: HMRC would normally expect that changes to an agreement in response to benchmark reform would not amount to a material change and there should therefore be no need to notify HMRC.
- **Reporting requirements:** Where reporting requirements (such as EU MDR) depend on a new financial instrument being created, HMRC would expect that amendments made in response to benchmark reform should not create a new financial instrument.
- **Transfer pricing:** Where the arm's length price of financial instruments is specified by reference to LIBOR, HMRC will normally accept that parties to a contract that references LIBOR would, acting at arm's length, agree to make changes to the contract to respond to the reform of the benchmark. It would not normally be necessary to reassess whether the terms of the original agreement are arm's length.
- **Clearances:** Existing clearances could involve financial instruments that need to be amended to replace references to LIBOR. Businesses will still be able to rely on the certainty given by the clearance, provided that:
  - the amendment does not affect the economics of the transaction; and
  - there is nothing significant in the tax analysis of the transaction that would be affected by the amendments.

UK - Finance bill and HMRC technical notes/consultation papers (cont'd)

R&D tax relief for SMEs

The Government has launched a second consultation on the introduction of a cap on the amount of SME scheme payable tax credit that a business can receive in any one year. The scheme allows companies to claim a tax credit worth up to 14.5% of the R&D element of their losses and receive a cash-flow benefit. At Budget 2018, the Government proposed a 'PAYE cap' to address abuse of the scheme, but the introduction of this cap was delayed until 1 April 2021 to allow for further consultation on the protections (as well as a £20,000 threshold below which the cap would not apply) which will be made available to genuine businesses affected by the cap.

The two carve outs proposed in the consultation are as follows:

- Where a claimant company can provide proof that they are actively managing the intellectual property arising from the R&D project, this could provide assurance that a claim for the credit could be uncapped.
- The Government intends to apply a test which allows for a limited proportion of R&D expenditure on subcontracting to, and provision of EPWs by, related parties; the permissibility of a low level of related party subcontracting is being considered by the Government.

A response to the consultation is currently being drafted by PwC, and we encourage Fund managers to get in touch if they have any comments or concerns.

New large business notification when taking a position HMRC is likely to challenge

The Government has released a consultation document seeking views on the proposed new notification requirements for large businesses (turnover above £200m or balance sheet over £2bn) that have adopted an uncertain tax position i.e. where a business believes HMRC may not agree with an interpretation of legislation, case law or guidance. 'Uncertain tax treatment' will be defined in the legislation and examples will be provided by HMRC in the guidance, but the consultation indicates that certain aspects of the definition will be drawn from IFRIC23.

It is anticipated that the legislation will be introduced in the 2020-2021 Finance Bill and will apply to returns filed after April 2021. Certain exclusions are expected to apply, such as any treatment disclosable under DOTAS, the DAC 6 rules, or uncertainty which is subject to formal discussion with HMRC.

Next steps for Alternative Investment Funds

The additional clarifications relating to the implementation of the UK DST and HMRC's proposed treatment of issues arising from the withdrawal of LIBOR will be helpful for Fund managers. They should ensure they understand how the new details could impact their business' structure and any financial arrangements to which they are a party. With regard to the consultations, Fund managers with particular concerns about the cap on R&D tax relief for SMEs or about the new large business notification proposals should make representations directly to HMRC or through PwC, or through industry bodies such as the IA, the BVCA or AIMA.

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UK – HMRC's post-Brexit plans for non-UK funds

Background

In March, HM Treasury ('HMT') consulted on the 'Overseas' fund regime (i.e. non-UK fund), setting out proposals for a new regime intended to make it easier for non-UK retail and money market ('MMFs') funds to be sold into the UK from January 2021.

The new regime, which will supersede the UK Temporary Permissions Regime, will be based on the principle of jurisdictional regulatory equivalence. Where individual funds are not eligible to be recognised through the overseas fund regime because they are domiciled in a country not covered by an equivalence determination, they may still be eligible for marketing in the UK under the existing section 272 of the Financial Services Markets Act (AIFs or other non-UCITS funds).

The consultation can be found here and closes on 11 May 2020.

What does this mean for Alternative Investment Funds?

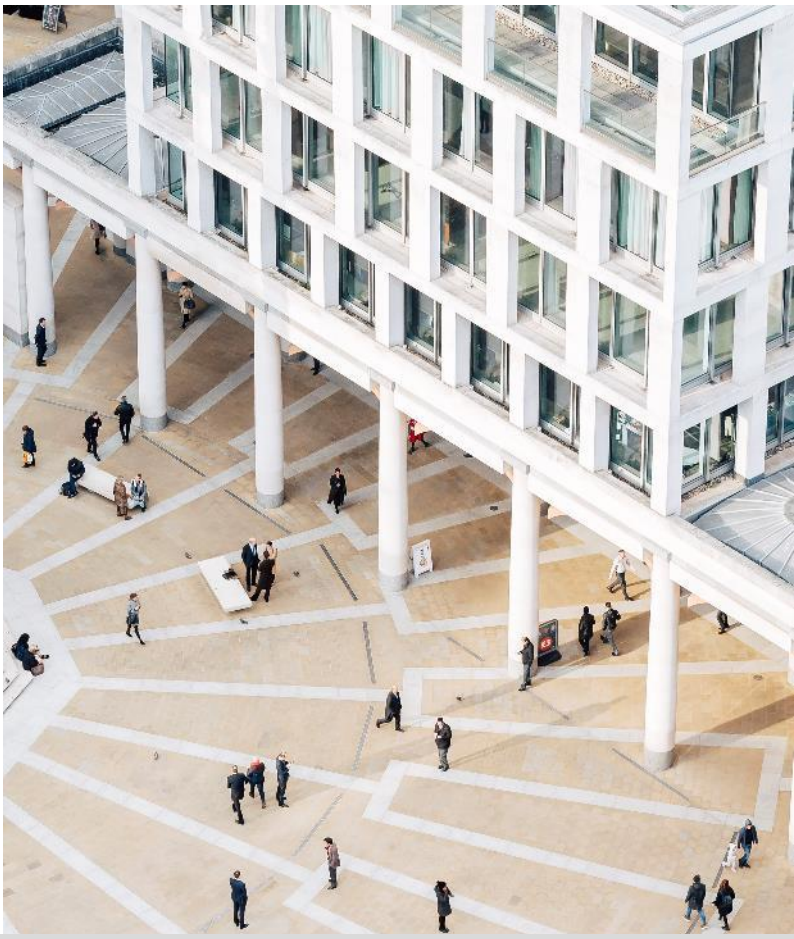
Non-UK retail and money market funds would be given permission to market into the UK, provided that the country in which the fund is domiciled has a regulatory regime that provides at least equivalent levels of investor protection to that offered by UK authorised funds.

To qualify for equivalence, there would need to be appropriate cooperation arrangements between the FCA and the relevant regulator in the fund's country of domicile.

Retail funds included in the equivalence decision may face additional requirements as a condition of UK recognition.

Non-retail money market funds with an equivalence determination will need to submit a notification to the FCA under the National Private Placement Regime.

HMT is also proposing to amend the section 272 process. This provides a mechanism for individual non-EEA funds to be recognised by the FCA where that fund meets several tests in legislation and affords sufficient protection to investors.



Next steps for Alternative Investment Funds

Alternative Investment Funds seeking to market non-UK retail and money market funds into the UK from 1 January 2021 will have planned on the basis that those funds may no longer be deemed equivalent. Now, if the proposals are introduced, non-UK funds in jurisdictions that are deemed equivalent may be able to rely on these equivalence measures, if the proposals are introduced. For other funds, the solution might be to establish mirror funds in the UK or become familiar with the section 272 process and the proposed amendments.

Alternative Investment Funds should also note the HMT's request for input on aspects of the UK framework that relate to the marketing of funds to UK retail investors, and their relevance within the Overseas fund regime. This includes the arrangements for alternative dispute resolution, financial compensation, disclosure, and financial promotions. The deadline to provide input is 11 May 2020.

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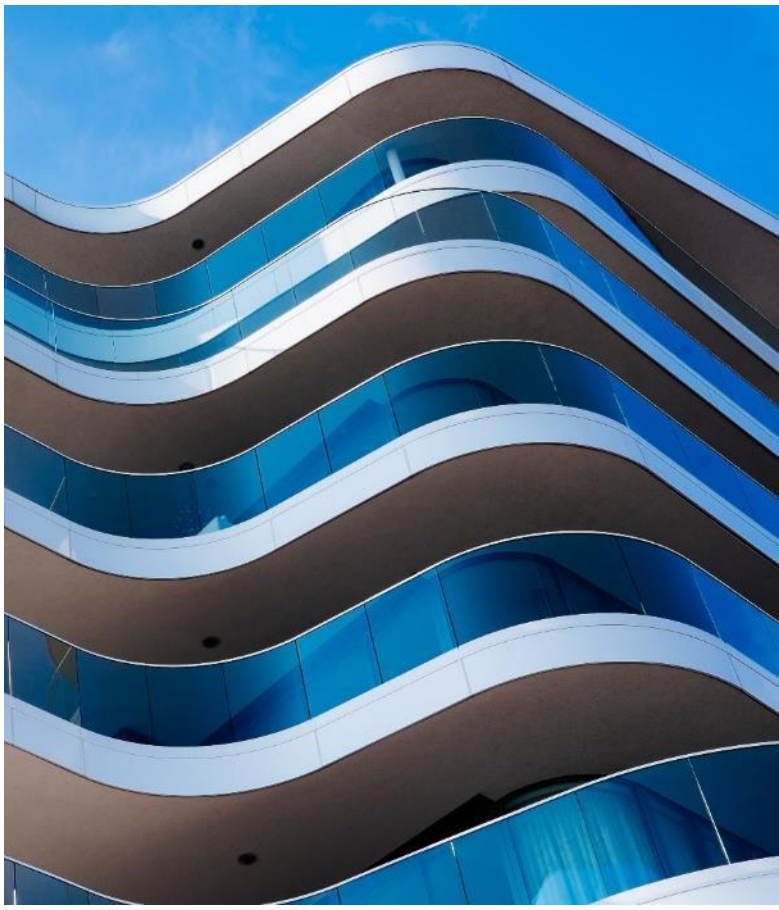
Italy – No access to domestic tax exemptions for transparent funds

Recently some custodians have reached out to Alternative Investment Fund Managers who were managing tax transparent funds and who were applying domestic withholding tax ('WHT') reliefs to those funds on their Italian investments. PwC's view is that tax transparent funds should not in principle apply domestic tax reliefs, as:

- Generally, all foreign entities (including funds and partnerships) should be considered opaque/non tax-transparent entities from an Italian domestic perspective (i.e., Italy should look at the fund/partnership and not the underlying investors).
- Participants in a transparent entity may get treaty but not domestic benefits;
- Participants in a transparent entity should not get any other benefits, such as the Pension Fund 11% WHT rate or the 1.2% EU corporate tax rate due to underlying pension fund or corporate investors.
- As such, the only way a fund could obtain the 11% or the 1.2% domestic WHT rate is for the fund itself to be considered as a pension fund or a corporate entity.

In the UK this is particularly important for an ACS with underlying pension fund investors and we have worked with some ACSs to analyse the fact patterns and understand whether, under the definition of Italian tax laws, it would be possible to requalify the ACS as a pension fund itself. However, even if the ACS did qualify as a pension fund, UK pension funds will lose entitlement to the 11% from 1/1/2021 (unless Brexit negotiations lead to a new agreement on this).



Next steps for Alternative Investment Funds

Where alternative investment funds have a transparent fund where the domestic tax rate has been applied, an analysis should be done to understand impact of future reliefs available and potentially apply for treaty reliefs as well as review the historic position and decide course of action for remediation if needed.

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EU and UK – A round of VAT updates

1. Deferral of VAT payments due

On 20th March the Chancellor announced that businesses with a VAT payment falling due between 20 March and 30 June would be permitted to defer this payment. This is to support businesses with liquidity in acknowledgement of the difficulties many businesses are facing as a consequence of the Coronavirus.

Further clarifications have since been issued by the government in relation to these measures.

Payments can be deferred until no later than 31 March 2021, and no interest nor penalties will be charged by HMRC on any amount deferred under these measures. Those availing themselves of this deferral should file VAT returns in accordance with the normal schedule, but do not need to pay HMRC. There is no application nor notification to HMRC required for this.

Deferral is available for VAT return payments and also for any payments on account due in this period.

These measures are unprecedented and demonstrate the UK Government's commitment to tackling the economic difficulty many businesses will face. All businesses that have, or will have, a payment (or payments) of VAT falling due in the period 20 March 2020 to 30 June 2020 should therefore fully consider whether this deferral could assist their business in these uncertain economic conditions.

For businesses in a refund position, this deferral will not create a benefit. For such businesses, it is possible to request a move to monthly VAT returns, which can accelerate the refunds and assist with liquidity. Such businesses should be aware that there will be additional administrative time required to prepare and file returns on a monthly basis.

Finally, we note that HMRC has announced on 30 March 2020 that the deadline for the implementation of digital links per Making Tax Digital has been delayed in acknowledgement again of the difficult position many businesses are in. These requirements will now come into effect for VAT periods commencing on or after 1 April 2021.

2. BlackRock – Advocate General Opinion

The European Court published the Advocate General's Opinion (the "AGO") in the BlackRock case earlier this month. In summary, the AG concluded that the provision of services relating to the BlackRock's Aladdin system could not benefit from VAT exemption, as the services were used for both special investment funds ("SIFs) and non-SIFs.

The question at issue in the BlackRock case was whether the provision of services relating to its Aladdin system could qualify for VAT exemption to the extent that these services relate to BlackRock's management of SIFs.

The reasoning adopted by the AG was that there was a single indivisible economic supply, which was offered as a complete package. Whilst there was prior European case law (such as Talacre, Commission v France and Commission v Luxembourg) that did allow for the apportionment of certain services, the AG felt that the fact patterns in these could be distinguished from the BlackRock case. These cases were, in the AG's view, exceptional, and did not set out general principles nor create a precedent in the present case.

The AG expressed reservations with the proposal that the VAT exemption should be apportioned based on the value of the assets under management for SIFs and non-SIFs respectively. Moreover, he felt that such a mechanism would undermine the nature of the VAT system to make it unworkable.

He did concede though it would be possible to confer the VAT exemption where either: a) the recipient of the service managed only SIFs, or b) the supplier of the services could provide detailed data enabling the tax authority to identify precisely and objectively the services provided specifically for a SIF.

There appear to be a number of unresolved points from the AGO's reasoning, in particular in his rejection of prior European jurisprudence, and we wait to hear if the CJEU will reach the same conclusion.

The AGO will disappoint many investment managers, as if this approach is endorsed by the European Court, this could lead to investment managers incurring irrecoverable VAT both upon Aladdin costs, and also upon other costs that are used by them towards the management of SIF and non-SIFs (such as investment research costs).

Should the CJEU follow the approach taken by the AG, many investment managers may need to consider their procurement models where purchasing services which relate to both SIF and non-SIFs.

3. HMRC – broadening of the VAT 'management' exemption - 1 April 2020

HMRC has confirmed that with effect from 1 April 2020, the VAT management exemption will be broadened to include the management of closed-ended collective investment undertakings that invest in assets other than securities, and also the management of "qualifying" pension funds.

EU and UK – A round of VAT updates (cont'd)

This change implements the CJEU court decisions in Fiscale Eenheid X, C-595/13 ("Fiscale Eenheid") and ATP PensionService A/S, C-464/12 ("ATP"). In summary, Fiscale Eenheid confirmed that funds investing in real estate could qualify as special investment funds, and therefore the management of such funds could be VAT exempt. In ATP, the CJEU considered that certain types of pension schemes could also qualify as special investment funds.

On the broadened of the management of closed-ended collective investment undertakings, it is expected that the management of Real Estate Investment Trusts ("REITs") will be one of the key areas impacted. However, the management of other funds that also invest in real estate may also be affected, for example Investment Trust Companies ("ITCs") that also invest in real estate.

It will be important for investment managers of REITs and other impacted funds to make the required system and invoicing changes to be compliant with the new rules as of 1 April 2020.

With regard to the management of certain pension funds post 1 April 2020, the definition of a "qualifying" pension fund is drawn by reference to the conditions referenced in ATP and applies to pension funds that are established in the United Kingdom or in an EU Member State. In practice, however, this change will mainly impact the management to UK defined contribution ("DC") pension funds.

Investment managers have, to date, experienced some resistance from HMRC in trying to agree that a particular pension fund is a DC pension scheme, and therefore that the management thereof could potentially qualify for VAT exemption. It is therefore hoped that this new statutory amendment will reduce the number of instances in which HMRC refuses to agree that the VAT exemption is applicable for DC pension schemes.

We also recommend that investment managers look to submit 'top-up' VAT claims for all VAT periods up to and including 31 March 2020 so as to ensure they protect their respective positions and those of their clients.

For those investment managers that currently provide services to pension funds located in EU Member States, correspondence and research will need to be carried out to verify whether those funds are "qualifying pension funds" per the new provisions. This may not be straightforward, particularly given the nuances to the forms of pension funds available across the EU. Nevertheless, HMRC will expect managers to review this on a client-by-client basis and also retain records of the enquiries that they have made in this regard.

We would advise investment managers and DC pension fund Boards to take the appropriate VAT advice, as this could be a potentially complex area and assistance may be required in any negotiations and/or resolution with HMRC.

4. Lease renegotiations and VAT consequences

One of the measures introduced in response to COVID are new rules to prevent landlords from evicting commercial tenants for a 3-month period.

Tenants looking at a variety of ways in which they can seek to manage this, not only during the 3-month period but going forward. We have already seen discussions taking place between landlords (including real estate funds) and tenants on a number of solutions and many of them could have an impact on VAT, potentially negative.

Areas which we see as particularly problematic are:

Terminations

Discussions on rent holidays, reduced rents or rent deferral.

Subletting and assignments - Looking to actively assign leases or sub-let to third parties, due to concern over vacancies

Repurposing (e.g. using empty student accommodation for other purposes)

If you are aware of any such conversations happening with tenants (or changes in the intentions for untenanted property), it is important to consider at an early stage how any such changes could affect the VAT treatment (including any impact upon historical VAT accounting), such that these can be managed, and/or included in the commercial considerations.

Finally, our VAT team is hosting an online VAT briefing session on 1 May 2020 – should you wish to attend please do let Daniel or Neil know.

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UK – Draft HMRC Guidance for EU Mandatory Disclosure Rules (DAC 6)

On 13 January 2020, final regulations to implement EU Directive 2018/822 ('DAC6') on the mandatory disclosure and exchange of cross-border arrangements were laid before Parliament and have become law. Final guidance is expected before the regulations come into force in July 2020 although draft guidance was published in March 2020 for further consultation, which we explore further in this article. From our discussions with HMRC it has been clear that they would like EU MDR to be applied in the UK in a pragmatic and targeted way, and in general the draft guidance reflects this intention. However if clients have reporting obligations in other EU countries, clients will need to consider the regulations and guidance in those countries, which may well be different from the UK.

The rules are very important for Fund managers and their Funds who themselves may be intermediaries with reporting obligations.

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. It is important to note that at this stage, there is no central EU expectation that the application date of the regulations will be delayed due to COVID-19. Although HMRC are considering whether the implementation dates could be delayed, we recommend clients proceed on the basis that the UK implementation dates will not change.

Aspects of the draft guidance will be helpful for Fund managers, although questions remain.

Welcome clarifications in the draft guidance:

- Main benefit test – The definition of "tax advantage" has been restricted to taxes to which DAC6 applies, i.e. EU direct taxes. This may reduce the number of arrangements disclosable under hallmarks subject to the main benefit test.
- Meaning of "concerning" - Helpful guidance is included explaining that HMRC only consider an arrangement to 'concern' a territory if that territory is of 'material relevance' to the arrangement, and provide a number of examples to illustrate the concept. Specifically, HMRC include an example of a CIV established for investors from any jurisdiction and confirm that the fact that investors could be from different jurisdictions does not inherently make this a cross-border arrangement assuming that the location of the investors is not material to the establishment of the CIV. Thought should therefore be given as to whether the investor jurisdiction has been specifically taken into account when establishing the fund.
- Hallmark A3 - HMRC have confirmed that industry standard framework agreements (such as an ISDA) should not normally satisfy this hallmark, on the assumption that they are usually subject to significant contract-specific customisation.
- C Hallmarks - "Recipient" – HMRC have confirmed that the recipient for the purposes of these hallmarks will generally be the person/people who is/are taxable on the receipt. In the case of transparent vehicles such as general partnerships, it will be the partners, rather than the partnership, who are taxable on the receipt so in this case, it would be the partners who are the recipients for the purposes of judging whether this hallmark is met.
- C Hallmarks - Territories without the concept of corporate tax (e.g. Cayman Islands)/"Resident for tax purposes" – HMRC have clarified whether payments to entities incorporated in territories without the concept of corporate tax should fall within hallmark C1a or either of the C1b hallmarks, and have confirmed that an entity incorporated in a jurisdiction without corporate tax should be considered under the Cb hallmarks. HMRC indicate that they consider that C1a is targeted at situations whether the non-residence arises due to a mismatch of taxing criteria between territories rather than due to the lack of tax residency concept in a jurisdiction.

UK – Draft HMRC Guidance for EU Mandatory Disclosure Rules (DAC 6) Published (cont'd)

- Hallmark Cb(ii) – notably the Cayman Islands – the draft HMRC guidance has clarified that it is necessary to consider whether the territory is on either of the EU or OECD list of uncooperative tax jurisdictions **both** at the time of the first step of implementation and 1 July 2020, to determine if an arrangement is disclosable under this hallmark. It follows that relevant arrangements involving the Cayman Islands that were implemented before the Cayman Islands was added to the "Blacklist" earlier this year may not be reportable under this hallmark (although do consider other hallmarks).
- Hallmark C4 - HMRC have set out their view that 'material' in this hallmark refers to a difference in consideration which does not result from the normal operation of the tax legislation, such that it would be reasonable to conclude that the tax authorities would want to understand more about the arrangement and its operation. This is significantly different from, say, an accountant's interpretation of 'material'. HMRC give the example of a transfer by a UK company of shares to a non-UK resident and that disposal benefits from SSE. As long as the transaction is undertaken in a manner consistent with the normal operation of the SSE legislation, there should not be a material difference, irrespective of the tax basis available to the transferee.
- HMRC indicate that, where the D hallmarks and the OECD's Mandatory Disclosure Regime rules cover the same ground, then HMRC will interpret the D hallmarks in line with the OECD's rules. Accordingly, the OECD's guidance on MDR should be capable of being used to interpret the D hallmarks. HMRC have also clarified that, just because an arrangement results in no CRS report being made, if this is in line with the policy objective of the CRS rules, this should not be disclosable under D1.

Potential challenges remaining following the draft guidance:

- Hallmark E3 - HMRC indicate that, when seeking to determine if hallmark E3 is satisfied, it is necessary to consider it from the point of view of a hypothetical informed observer. More specifically, based on all the facts and circumstances, would a reasonable person consider that, on the balance of probabilities, the expected EBIT of the transferor should decrease by at least 50% in the following three years? This is therefore a subjective test.
- HMRC accept that intermediaries who are service providers may not know all details of an arrangement and are not required to do additional due diligence beyond that necessary to perform their services. This could result in disclosure obligations transferring to other intermediaries or taxpayers.
- Disclosure in the UK and the EU – Whilst HMRC's approach, as reflected in the UK draft guidance is generally pragmatic and helpful, arrangements may still be disclosable in the EU even if not in the UK.

Matters on which further clarification is still necessary:

- US LLCs – Concern remains over the status of a US LLC if it is not considered tax resident anywhere. Further clarification is being sough as to whether LLC's should be 'looked through'.
- Hallmark E3 and Brexit – HMRC does not consider that it would be appropriate to carve out Brexit-related reorganisations from the legislation and the draft guidance does not shed any further light here. However, HMRC will explore whether steps can be taken to minimise over-reporting of benign transactions through further guidance. Guidance will also address sector specific issues such as the application of the EBIT test to financial sector entities and funds.
- Penalties - The draft guidance currently only sets out the circumstances in which a person may be liable for a penalty. Further guidance on penalties is to follow.

UK – Draft HMRC Guidance for EU Mandatory Disclosure Rules (DAC 6) Published (cont'd)

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What we are seeing our clients do to prepare

We are seeing clear trends emerging on implementation preparation. This includes Fund managers 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.

For Fund managers who have repeat transactions, positions are being documented and opinions sought to ensure that where arrangements are considered not reportable, sufficient evidence is available for the position to be adopted going forward.

We are seeing Fund 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.

Next steps for Alternative Investment Funds

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. Businesses should be mindful that not all EU members states follow the same guidance and some may not require certain intermediaries to have a reporting obligation so, businesses should assess the areas where increased internal oversight of reporting obligations is required. There are still a number of technical areas that remain unclear and practical considerations for HMRC to review further, however, our thinking is well advanced and we are continuing to liaise with HMRC on the industry issues.

Operational readiness for compliance is also important as many Alternative 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.

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