Keeping up with Alternative Investment Funds

August 2020

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Introduction

Welcome to our August edition of Keeping up with Alternative Investment Funds. As was at the time of our previous edition, we continue to see the lifting of certain lockdown measures by Government, and the economy and wider environment begins to head towards some form of normality, we continue to live in unpredictable and challenging times. We hope you and your families continue to remain safe and well.

As various new measures are being announced by government in response to the pandemic, our **COVID-19 website** will be updated regularly with the latest guidance, updates, and details of how we can offer help and support to businesses, from crisis scenario planning, to cashflow management and cyber security.

Our next roundtable event for clients will be held in September; this will focus on the FCA's Investment Funds Regime ("IFR") which will come into force in 2021. We will cover the new regime with a focus on capital requirements, the impact on M&A deals and remuneration polices and reward delivery and the potential tax issues arising from IFR. We very much hope you are able to join us then.

Looking ahead, we are still keen to hear feedback from clients on the virtual client roundtables held to date regarding frequency (bi-monthly vs monthly), content, format and any suggested topics to be covered at future events. Please contact **richard.madden@pwc.com** or **robert.mellor@pwc.com** if you have any feedback or suggestions.

Our August newsletter covers a wide variety of topics including ATAD II and broader workforce issues in light of COVID-19, as well as things to consider for alternative investments funds around Pillar 1 and Pillar 2.

See the full list of articles in this newsletter below:

- ATAD II – Practical challenges for alternative investment funds
- Office of Tax Simplification Capital Gains Tax review
- The Singapore Variable Capital Company
- Pillar 1 and Pillar 2 – Considerations for alternative fund managers
- Irish anti-hybrids rules

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 in the future.

Kind regards,

PwC Alternative Investment Funds team

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News Bulletin

Brexit Update - FCA, ESMA and EU national securities regulators confirm Memorandum of Understanding ("MoUs") will come into effect at the end of the transition period

In July's edition of the newsletter we featured an article on how no deal preparedness was rising back up on the agenda. Since then there have been some updates, which are detailed below.

On 17 July there was an important and reassuring confirmation from the FCA, ESMA and EU national securities regulators that the MoUs that were agreed on 1 February 2019 covering cooperation and exchange of information will come into effect at the end of the transition period, which is of course due to end on 31 December 2020.

Back in February 2019 the FCA and ESMA announced that these MoUs had been agreed in the event the UK left the EU without a withdrawal agreement. Given that the UK did in fact leave the EU under the terms of the Withdrawal Agreement on 31 January 2020, there was some concern that these MoUs were no longer required and may not come into effect upon the expiry of the transition period on 31 December 2020.

The MoUs are expected to cover the cooperation agreements required to allow certain activities, such as fund manager outsourcing and delegation, to continue to be carried out by UK based entities on behalf of counterparties based in the European Economic Area ("EEA").

This brings some much needed clarity to Alternative Investment Fund Managers finalising their Brexit contingency plans who may be concerned about a potential cliff-edge scenario if the permissions to delegate such activities to a UK entity was withdrawn.

However, ESMA longer term plans around outsourcing and delegation by EU funds outside of the EU are still an area of concern for the UK asset management industry.

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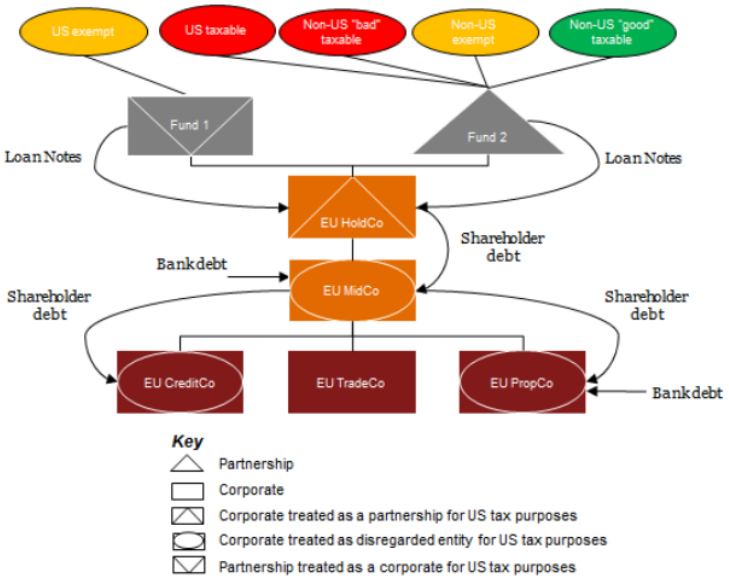
ATAD II – Practical challenges for alternative investment funds – Focus on real estate



Background

The second European Anti-Tax-Avoidance Directive ("Council Directive 2017/952/EU", or "ATAD 2") implements the OECD's Base Erosion and Profit-Shifting Action 2 final report (on neutralizing the effects of hybrid mismatch arrangements) at the EU level. ATAD 2 strengthens rules targeting hybrid mismatches arising between member states and extends the scope to include mismatches between member states and third countries.

The directive requires member states to transpose its contents into domestic law by 1 January 2020 and broadly targets structures where:

- There is either a double deduction or deduction/non-inclusion mismatch;
- The mismatch arises as a result of a hybrid entity or a hybrid instrument; and
- The mismatch is between associated enterprises or parties to a structured arrangement.

This article highlights some of the practical challenges facing investors and fund managers on the implementation of ATAD2 across the EU.

Practical takeaway: Deductions for certain financing and non-financing expenses may be disallowed from 1 January 2020. Funds should consider existing structures which may be at risk and proactively manage ATAD2 risks on new fund structuring.

Associated enterprises/ structured arrangement

Enterprises are considered to be associated with each other where one has "control" of the other - i.e. at least a 50% voting or economic interest (lowered to 25% for hybrid instrument mismatches). For these purposes, investors in the fund partnership managed by a common general partner are generally considered to be acting together to control the underlying structure (subject to certain relaxations in member state implementation).

A structured arrangement is an arrangement involving a hybrid mismatch that prices the mismatch outcome into the terms, or an arrangement that has been designed to produce a hybrid mismatch outcome. There is a risk that US transparency elections are considered to be such a structured arrangement.

Practical takeaway: Funds should consider whether ATAD2 implementation in member states relevant to the structure have any relaxations on "acting together" and specific guidance around "structured arrangements".

Double deduction mismatches ("DD")

DD mismatches typically occur where the same expense is tax deductible in two different countries.

For example, in the attached diagram, interest deductions arising on bank debt in PropCo and MidCo (and other expenses such as employee costs) may also be deductible for US taxable investors, due to US transparency elections in the structure.

Where this is matched by income that is also taxable in two different countries (e.g. PropCo rental income), no disallowance should arise.

However, a disallowance of third party expenses can arise where the expenses exceed income (e.g. insufficient PropCo rental income) or - more commonly - where the same income is not taxable twice (e.g. MidCo interest income on shareholder loans is disregarded for US purposes).

Practical takeaway: Funds should consider whether any expenses at risk of DD mismatches are matched by relevant taxable income. DD mismatches can arise without any overall economic mismatch (e.g. for MidCo).

ATAD II – Practical challenges for alternative investment funds – Focus on real estate cont.

Deduction/non-inclusion mismatches ("DNI")

Most fund structures do not have direct DNI mismatches due to the common use of treaty eligible holding platforms. For example, in the above diagram, interest deductions arising in PropCo or CreditCo on shareholder loans should be matched by taxable income arising to MidCo.

However, as the interest payment in PropCo/CreditCo ultimately funds Loan Note ("LN") payments by HoldCo, it is necessary to consider whether any mismatch at HoldCo (which is not counteracted in HoldCo's jurisdiction) can be "imported" to disallow shareholder loan deductions in PropCo/CreditCo.

In this context, the two most common mismatches in fund structures are:

- Hybrid instrument mismatches; and
- Hybrid entity payee mismatches.

Hybrid instrument mismatches

A DNI mismatch on hybrid instruments arises where the deduction obtained by the borrower is not fully matched by taxable income in the lender, within a reasonable period of time, due to the terms of the instrument.

For example, in the attached diagram, there is a risk that certain taxable investors (e.g. US) may consider the LNs to be equity for local tax purposes and therefore tax income on a receipts basis - and possibly - at lower rates than interest income.

Depending on the implementation of ATAD 2 in each member state, it is also possible for exempt investors in such territories (e.g. US) to be deemed to cause a DNI mismatch, on the basis that late-taxation/non-taxation of LN income arises due to their treatment of the instrument as equity, as well as their exempt nature.

Practical takeaway: Consider whether any fund investors obtain a timing or tax rate advantage as a result of shareholder loan terms and whether ATAD 2 implementation in the member states relevant to the structure can deem certain exempt investors to also cause such a hybrid mismatch.

Hybrid entity payee mismatches

A DNI mismatch can also arise where the deduction obtained by the borrower is not fully matched by taxable income in the lender, due to the lender/investor treating partnerships as corporations.

For example, in the attached diagram, there is a risk that certain taxable investors (e.g. Australian, Dutch, Korean) may consider Fund 2 to be a corporation for local purposes and therefore tax "distributions" from Fund 2 on a cash basis (or exempt distributions) rather than tax LN income arising to Fund 2 on an accruals basis.

Depending on the implementation of ATAD 2 in each member state, it is also possible for exempt investors in such territories to be deemed to cause a DNI mismatch, on the basis that late-taxation/non-taxation of LN income arises due to the treatment of Fund 2 (and Fund 1) as a corporation, as well as their exempt nature.

From 1 January 2022, fund partnerships established in the EU may also become taxable locally where income arising to the partnership is not taxed by investors - even where there is no underlying DNI mismatch.

Practical takeaway: Consider whether any fund investors consider partnerships to be corporations (due to tax elections or general treatment under local law) and whether ATAD 2 implementation in the member states relevant to the structure can deem certain exempt investors to also cause such a hybrid mismatch.

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Office of Tax Simplification Capital Gains Tax review

You may have seen in the papers that the Chancellor has asked the Office of Tax Simplification ("OTS") to review capital gains tax ("CGT"). In particular, Rishi Sunak asked them to offer views on how to simplify the tax and also investigate aspects of the tax that may not be fit for purpose. There has therefore been a lot of speculation as to whether this means that there will be changes to capital gains tax in the future and that is obviously of interest to alternative fund managers.

The OTS does review the tax system at regular intervals but it does so from the perspective of tax simplification. It does not, for example, recommend significant changes to tax policy and does not consider what tax rates are appropriate. These areas are solely the remit of the government.

While the government does respond to recommendations made by the OTS, it does not necessarily accept or follow them. For example, its review of inheritance tax last year has resulted in no changes to-date.

At the moment capital gains tax accounts for around 1% of revenue raised by the government and COVID-19 has obviously created a need to raise more revenue. There has been speculation that one way of doing this is to increase the revenue raised by CGT and part of this speculation may have been driven by Warwick University's report "How much tax do the rich really pay?". One of the most striking findings in the report is that those receiving £10 million effectively paid just a 21 per cent tax rate on average.

This report suggests that the debate on tax is reframed "instead of asking 'can the rich pay more?', a better question may therefore be: 'who amongst the rich is not paying their fair share?'" While it does mention that taxing carried interest at income tax rates could raise up to £440 million (based on the data it used), this type of question is very much a political one and very unlikely to be something that the OTS would make recommendations on.

The OTS will work in two stages:

(i) high-level comments on the principles of CGT by 10 August 2020, and

(ii) more detailed comments on the technical detail and practical operation of CGT by 12 October 2020.

This is likely to allow the OTS to report by the time of the Budget 2020. Although the date has yet to be fixed, it is likely to be towards the end of November or early December.

We will engage with the OTS on this in the usual way. If you have any comments you would like us to pass onto them, please let us know. Similarly, if at any stage you want to chat about the issues and how they might affect you, please get in touch with the authors your normal PwC contact.

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The Singapore Variable Capital Company

Overview

Enacted on 15 January 2020, the Singapore Variable Capital Company ("VCC") legislation represents the city-state's latest investment fund innovation.

Just as the Undertakings for Collective Investments in Transferable Securities ("UCITS") transformed the investment fund industry in Europe, Asia is on the precipice of an investment fund evolution catalysed by the upcoming Asia Region Fund Passports ("ARFP"), supplementing the existing Association of South-east Asian nations Collective Investment Scheme ("ASEAN CIS") fund passport scheme catering to the South-east Asian region. The VCC regime stands poised to take the fullest opportunity of fund schemes in the region, as well as any potential passport marketing of alternative investment funds into Europe.

Singapore currently offers a variety of investment fund forms, such as limited partnerships, unit trusts, business trusts, and real estate investment trusts. Corporations are currently mainly used as investment subsidiaries for "fund" investments. The addition of the VCC to this suite of legal entities is key to elevating Singapore's value proposition as a competitive asset management hub in the region.

Corporate form funds are not a novelty in Singapore, as most private equity and real estate funds in Singapore today already use some form of Singapore corporate entity as an investment subsidiary within their fund structures. Further, over 70% of offshore funds sold in Singapore are corporate form funds domiciled in foreign locations.

Some key features of the VCC structure

- Can be used for alternative fund strategies intended for sophisticated investors or for traditional fund strategies intended for retail investors
- Can be set up as an open-ended or close-ended fund
- Can be set up as a stand-alone entity or as an umbrella entity with multiple sub-funds
- Foreign corporate funds can be re-domiciled into Singapore as VCCs
- Under no obligation to make either its financial statements or its shareholder lists publicly available
- Allows both entry into and exit from the fund at net asset value; and
- Could avail itself of the US "check-the-box" election

VCC in the marketplace

In the 7 months since the establishment of the VCC structure, over 90 VCCs have been set up and registered.

As a general timeline, there are five main steps in setting up a VCC:

(i) Determining your parties and preparing key documents - key players such as the directors, initial shareholders, company secretary, investment manager and auditor should be ascertained. Key documents should also be drafted at this stage, such as offering documents, the investment management agreement, the tax incentive scheme application and the VCC's constitution.

(ii) Reserving the name of the VCC - the proposed VCC's name must be approved by and reserved with the Registrar of VCCs; the Accounting and Corporate Regulatory Authority ("ACRA").

(iii) Registering the VCC - the registration documents must be filed with ACRA including the VCC's constitution, certain declarations from key players and the online registration form.

(iv) Registering sub-funds - for umbrella VCCs, sub-funds under the umbrella should be registered after the VCC has been formed and after the sub-funds have been formed.

(v) Application for tax incentive schemes – the relevant application form and accompanying documents must be filed with the Monetary Authority of Singapore ("MAS").

In general, ACRA will take around 14 days to process an application once all the required documents have been submitted (as in stages (ii), (iii), and (iv)), although a longer processing time may be required where approval from other public authorities is necessary.

For the tax incentive scheme application with MAS, processing will generally take around 8 to 12 weeks from the date of submission. The incentive is effective retroactively from the date of application.

Where a corporate fund entity is being re-domiciled into Singapore as a VCC, the process of transferring the entity's registration will replace step (iii), requiring similar documents, and will take around 60 days.

The Singapore Variable Capital Company cont.

Comparative advantages

The VCC is the result of a culmination of research and studies into the various fund vehicles used in other popular fund domiciles such as the Cayman Islands, Republic of Ireland, Luxembourg, UK and Mauritius. Today, Singapore funds are sold in Singapore, Malaysia and Thailand, through the ASEAN CIS fund passport scheme. Singapore's popularity in cross border funds can grow further if it were to join the upcoming larger passport scheme in Asia, namely the Asia Region Funds Passport.

Governance – In comparison, the governance framework of the VCC is mostly on par with other fund centres. A VCC only requires one locally resident director, which is less compared to other fund centres. In addition, it does not mandate the need for "independent" directors with regard to alternative funds marketed to non-retail investors. However, VCC legislation does require representation of at least one director of the fund management company on the board of the VCC. This is comparable to other on-shore jurisdictions such as Ireland and Luxembourg, where regulators encourage the "promoter" of the fund to have representation on the board of the fund.

Fund Manager – A key differentiator of the VCC regime is the requirement that the fund manager be located in Singapore. It does not require a minimum capital requirement to either launch or maintain the VCC.

Reports and Registers – In comparison to other jurisdictions, VCCs may only use International and Singapore financial reporting standards. Similar to other jurisdictions it does allow for financial statements to be prepared on a sub-fund basis. Funds set up in Singapore today as "companies" suffer from the drawback of having their financial statements and shareholders information publicly retrievable, however, the VCC regime does not provide for financial statements and shareholders' information to be made publicly available, thus matching the requirements of most fund centres around the world. However, shareholder registers of VCC must be made available to regulators for inspection upon request.

Check-the-box and Re-domiciliation – As US investors make up a significant portion of the global investor base, the VCC is allowed to make the "check-the-box" election, enabling US investors in the VCC to make use of the US tax pass-through treatment. This enables US taxable investors to invest directly into a VCC, hence potentially dispensing of the need to have specific US taxable investor pooling funds (i.e. a feeder fund) in another jurisdiction specifically for this purpose. This feature enhances the VCC's competitiveness in the US market and sets it on par with most of the fund domiciles.

The Singapore Variable Capital Company cont.

Another competitive feature of the VCC is the provision to re-domicile inwards. This addresses the key reasons behind requests for re-domiciliation by accommodating desired changes in the jurisdiction of the fund.

Tax – Singapore has a wide network of tax treaties, particularly with countries in the Asia Pacific region. Being a body corporate (as opposed to a unit trust, which does not have a legal personality), the VCC can meet one of the requirements for accessing benefits under Singapore's tax treaties. However, treaty eligibility needs to be analysed on a case-by-case basis, and is recommended to be monitored constantly, taking into consideration the country-specific and global developments regarding the eligibility of collective investment vehicles to access double tax treaties.

Within Singapore, the VCC will be treated as a company and a single entity for tax purposes, and will be subject to income tax. However, the tax exemption under sections 13R (referred to as "Singapore Resident Fund Scheme" or "SRF") and 13X (referred to as "Enhanced-Tier Fund Scheme" or "ETF") of the Income Tax Act of Singapore will be extended to VCCs, assuming that the conditions of those exemptions are met.

Service Providers – A progressive fund legal framework is not the only aspect that makes a jurisdiction competitive. The sophistication of a jurisdiction's ecosystem also has a key role to play. Singapore has evolved to house the world's leading custodians, fund administrators and other service providers. Compared to other jurisdictions, Singapore's progressive approach in developing the local service provider marketplace will help to enhance and develop the overall fund ecosystem in the long term. This is becoming increasingly important with the introduction of BEPS and the need to demonstrate substance in structure and operations.

Other Features – Other features such as listing ability, the possibility to dispense of annual general meetings, and cross sub-fund investing also makes VCC a competitive vehicle and puts it on par with corporate fund structures in other jurisdictions.

How can PwC assist?

PwC Singapore is proud to be the pioneer of the VCC and was the sole consultant to the Singapore Government on its development.

At each step of the process, PwC can assist readiness advisory, in preparing the legal documents of the VCC, incorporating or assisting with re-domiciling, tax advisory, applying to tax incentives, FATCA and CRS registration and advisory, licensing and registration of the fund management entity, and as part of on-going services – audit of the fund management entity and the VCC and tax compliance of such entities.

For more information: https://www.pwc.com/sg/en/asset-management/singapore-variable-capital-company.html

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Pillar 1 and Pillar 2 - Considerations for alternative fund managers

Introduction

Further to our previous updates on the OECD's proposals on Pillar 1, which looks at revising profit allocation nexus rules to increase taxable income allocated to markets, and Pillar 2, which is around the introduction of a global minimum rate of corporation tax, this article provides an overview of the latest technical and political developments and what this means for alternatives fund managers.

Where are we now?

There remain numerous challenges - both technical and political - standing in the way of reaching a multilateral consensus on the Pillar 1 and Pillar 2 rules.

Most recently, on the 3rd August, a draft Pillar 1 blueprint report was shared with delegates of the OECD Inclusive Framework (IF), with a final version expected to be published in October 2020. It is understood that the 227 page report contains a revised and more detailed proposal for Pillar 1, building on the proposals for a "Unified Approach" released by the OECD in 2019. Further detail on what the latest proposals could mean for alternative fund managers and investment structures is included in the following section.

There have also been a number of recent political developments. Most notably, the US Treasury has called for negotiations of Pillar 1 to be put on hold to enable the US and other countries to focus on responding to the economic issues arising from the COVID-19 pandemic. As a result of this, commentators are suggesting that it is difficult to agree on anything before the US elections. Linked to this, at the beginning of June the United States Trade Representative ("USTR") started investigations into digital services taxes ("DSTs") considered by several trading partners, including the EU and the UK.

Whilst most countries are calling for the work on Pillar 1 and 2 to be moved forward, it now looks like any political agreement is more likely to occur in the first half of next year, rather than later this year. That said, the OECD's July 2020 report to the G20 stated that "significant progress has been made on the technical development of both [Pillar 1 and Pillar 2]" in recent months, noting that "the technical development should be advanced enough to allow key political decisions to be taken on both pillars in October 2020".

What does this mean for alternative fund managers?

Pillar 1 - **considerations for managers**: It is understood that the August 2020 Pillar 1 draft blueprint paper indicates that financial services will be outside the scope of Pillar 1 (at least in respect of Amount A, which deals with the reallocation of 'non-routine' profits to market jurisdictions). This is in line with the paper released by the OECD in January 2020. The definition of financial services is expected to include asset management. Pillar 1 will instead focus on 'automated digital services' and 'other consumer facing businesses', subject to certain nexus standards and revenue thresholds.

Pillar 2 - **considerations for managers**: At present, no industry or sector carve outs are expected for Pillar 2. However, the impact of Pillar 2 for management group structures is expected to be limited, unless groups have significant operations in low / no tax jurisdictions. Provided there is a carve out for investment structures (see below), Pillar 2 is therefore likely to be largely a compliance exercise for most alternative fund managers.

Pillar 1 and Pillar 2 - Considerations for alternative fund managers cont.

Pillar 2 - considerations for investment structures: The key question for alternative fund managers is whether investment structures will be caught by the rules. Alternative investment fund managers have been lobbying for a carve out for investment structures, on the basis that it is a commonly accepted principle that such structures are not generally subject to tax, to ensure that there is no distortion in investing indirectly compared to investing directly, and that including investment structures would introduce unintended distortions into the capital markets. It is also clear that it is not the policy intention of Pillar 2 to introduce a minimum tax to investment structures.

Considerations for investment portfolios: The potential impact on the investments of the fund(s) will vary depending on the nature of those investments, with funds investing in digital-orientated and intangible-intensive sectors expected to be the most heavily impacted by both Pillars. For businesses with operations in low or zero tax jurisdictions Pillar 2 could lead to a significant tax cost, particularly if they have high overall profitability. In most cases the impact of Pillar 1 on a group's effective tax rate is expected to be modest, but it could significantly impact the compliance burden for those impacted. Understanding the latest position on nexus and scope will be important in assessing the impact here.

The takeaway

Despite the recent statement from the US, it is likely that the technical work on both Pillar 1 and Pillar 2 will continue, providing further opportunities for the business community to feed into the OECD technical process. Any substantial delays are likely to lead to trade conflicts as unilateral measures introduced by different countries could be met with retaliatory responses by the US, absent an agreement at the OECD.

Alternative fund managers should continue to assess the potential impact of Pillars 1 and 2 on their business, particularly on the underlying investment portfolios of their funds. Modelling the impact of Pillar 2 will be critical for those operating in low or zero tax jurisdictions.

As the potential implementation of Pillar I gets delayed it is likely to put greater focus on unilateral digital services taxes which many countries have implemented and also the extent to which they will impact the asset management sector. It is also likely that it will make them potentially more difficult to unwind as the process of Pillar I gets further delayed.

Finally, these changes in the corporate tax field must also be placed into the broader context that includes significant political pressures around the world, major (and ongoing) reform of international indirect tax rules (e.g. VAT) and broader trade policy concerns such as disputes at the World Trade Organisation.

Next steps for alternative investment funds

Alternative fund managers should continue to assess the potential impact of Pillars 1 and 2 on their business, particularly on the underlying investment portfolios of their funds. Modelling the impact of Pillar 2 will be critical for those operating in low or zero tax jurisdictions, and assessing the impact for investment structures will also be important if there is no carve out.

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Irish anti-hybrids rules

Further to our May newsletter, PwC Ireland's Alternative Investments Tax Team are taking a deeper dive into specific areas that are of relevance for key players within the Irish Alternative Fund industry. As highlighted in the last article, there are considerable changes from a domestic and EU-level tax perspective that are likely to directly impact Irish structures in the alternative fund space. A major recent change relates to the introduction of Irish anti-hybrid legislation.

Introduction

ATAD II, which was approved by EU Member States on 29 May 2017, required the introduction of anti-hybrid rules with effect from 1 January 2020 and the applicable Irish legislation was included in Finance Act 2019.The legislation came into effect for payments made, or arising, on or after 1 January 2020. With the recent release of the first tranche of the Irish Revenue's guidance notes on Irish anti-hybrid legislation, it is timely to consider further how these rules may impact typical Irish alternative investment structures.

As noted in the May newsletter and analysed elsewhere in this months KUWAIF publication, the anti-hybrid rules are extremely complex particularly when applied to multi-tiered, multi-jurisdictional structures that are typical in the alternatives industry. In our view, the consultative approach taken by the Irish authorities both during the legislative and Revenue guidance process has resulted in the development of balanced legislation and guidance which we have explored further below. Notwithstanding this approach the complexity of the rules should not be underestimated.

Overview of the Irish rules

The Irish anti-hybrid rules are designed to apply to arrangements made between associated enterprises. Parties can be associated if shareholding, voting rights or profit distribution thresholds are met (typically a 25% relationship applies here but it is increased to 50% in certain circumstances), if the entities are consolidated for accounting purposes, or if one entity has "significant influence in the management of the other". That final concept is defined to cover circumstances where an entity has the right to participate on the board of directors of another entity or in the "financial and operating policy decisions of that entity".

The main thrust of the rules are aimed at preventing companies from benefiting from differences in the tax treatment of payments made under hybrid financial instruments and on payments by or to hybrid entities. Hybrid financial instruments are broadly those which are treated as debt in one jurisdiction but equity in another (e.g. Profit Participating Notes/Loans which are viewed as debt in Ireland but often viewed as equity in other jurisdictions such as the US), while a hybrid entity is typically viewed as opaque in one jurisdiction but transparent in another (e.g. a US "check-the-box" election which can give certain entities such as an ICAV or S.110 company a specific US tax designation). This tax system arbitrage can result in companies qualifying for tax relief on payments in one jurisdiction without being taxed on the other side in the hands of the recipient in their local jurisdiction (so-called Deduction No Inclusion or 'DNI' situations) or in qualifying for tax relief in more than one jurisdiction on the same payment (Double Deduction or 'DD' situations). The new rules will deny deductions for such payments or, in certain circumstances, will subject them to tax in Ireland, but only to the extent that the DNI or DD outcomes are caused by hybridity.

The anti-hybrid rules can also apply to transactions between parties that are unconnected if the transaction is a 'structured arrangement'. That term covers transactions that give rise to a mismatch outcome where (a) the mismatch outcome is priced into the terms of the arrangement or (b) the arrangement was designed to give rise to a mismatch outcome. The anti-hybrid rules will apply only to taxpayers who share in the value of a tax benefit arising from a structured arrangement.

Another important area covered by the rules relates to imported mismatches. This provision seeks to target deductible payments from Ireland which directly or indirectly fund hybrid mismatches outside of Ireland. Finally, areas such as disregarded permanent establishment, tax residency mismatch outcomes and withholding tax mismatch outcomes are contained in the Irish anti-hybrid rules but such areas are not typically prevalent concerns for Irish alternative investment structures.

Irish anti-hybrids rules cont.

Positive Irish measures

Ireland has adopted a practical approach in the transposition of the ATAD II rules (see the first article in this newsletter) into Irish legislation. The overarching aim of capturing hybrid mismatch outcomes and meeting the minimum standard of ATAD II has been achieved in a manner which allows taxpayers to apply (and Irish Revenue to police) the rules in a sensible manner. We have set out some of the key provisions which are helpful from an alternatives industry perspective.

Associated enterprise definition

The definition of associated enterprises is in line with the minimum standard of ATAD II and will clearly capture investors in certain fund structures, although helpfully debt relationships are not explicitly included within the definition. “Acting together” provisions will need to be considered for certain partnership structures where the aforementioned 25%/50% shareholding, voting or profit distribution rights are held by investors.

Inclusion and payee definition

Another very important concept is that of “inclusion” because provided the payment is included in the recipient’s location, no deductibility restrictions apply. The typical alternative investment structures include an abundance of vehicles of both an opaque and transparent tax nature (such as US LLCs, LPs and UK LLPs). As a result, the search for a “payee” or recipient of the payment, and the subsequent test for inclusion, can be quite unwieldy and create a significant administrative burden.

The Irish definition of “inclusion” covers not just payments that are subject to tax in the overseas jurisdiction, but also payments to exempt foreign entities such as pension funds, government bodies etc. Furthermore, payments to entities that are located in a jurisdiction that does not impose tax are treated as included provided that the profits or gains are treated as arising or accruing to that entity. A CFC-type charge (including Global Intangible Low Taxed Income (“GILTI”) and Passive Foreign Investment Company (“PFIC”)) imposed under the laws of another territory will also be treated as included. Ireland has helpfully included a broad definition of payee to cater for situations where Ireland may view the initial “payee” as opaque but there is inclusion for a so called “participator” behind that initial payee. A participator is also viewed as a payee under Irish legislation. This can, in certain cases (e.g. a payment to a US LLC), result in scenarios where there are multiple payees in the structure. Helpfully, the recently published guidance states that where multiple payees can be identified in a structure, the test for ‘inclusion’ will be satisfied where the payment is included by at least one payee.

Irish anti-hybrids rules cont.

Dual inclusion concepts

Similarly, the concept of dual inclusion is a very important concept for alternative investment structures. In situations where a payment by a hybrid entity or a double deduction scenario arises, no restriction applies as long as the payment can be offset against "dual inclusion income". This is income which is subject to tax in both Ireland and the jurisdiction where the mismatch situation arises. Many structures have US flow through tax treatment, due to multi-tiered check the box elections, which can result in significant double deduction outcomes. In many cases, those deductions are not at asset owning entity level, but at mid tier levels which can create complexity in identifying the corresponding dual included income in certain cases. Ireland has introduced a jurisdictional, as opposed to entity by entity, test for dual inclusion purposes. Accordingly, provided there is economic inclusion in Ireland (regardless of whether the expense deduction is in a different Irish entity to the Irish entity where the income is dual included) Ireland will view that income as "included" for dual inclusion purposes. Further, payments into Ireland from within the same US check-the-box-group can be treated as included by the US. However, this is subject to an anti-avoidance rule which can still take effect where in substance there is a hybrid mismatch. There are a number of helpful examples set out in the Revenue Guidance that demonstrate in detail where this situation can arise.

Imported mismatch rules

As noted above, imported mismatch provisions cover deductible payments from Ireland which directly or indirectly fund hybrid mismatches outside of Ireland. It is clear that this rule has the ability to be very broad in scope particularly for alternative investment structures. Irish legislation prescribed that these rules do not apply where payments are made to other EU Member States which is a very positive development. For payments to non-EU territories, similar to the UK rules, the legislation affords the opportunity to place reliance on anti hybrid rules in another territory which are aligned with the OECD BEPS Action 2 recommendations in certain cases. The charging section is also prefaced by "reasonable to consider" language which is helpful in the context of multi-tiered investment structures.

Next steps for alternative investment funds

The Irish anti-hybrid legislation is live and many clients have completed their impact assessments. While drafted in a sensible manner, the rules are extremely complex and do still bite on many occasions. This has resulted in a number of clients being caught by these rules. Consequently, if you haven't already done so, we would strongly recommend that an impact assessment of your Irish structures is completed as soon as possible. We expect to see further guidance issued by the Irish Revenue with respect to the anti-hybrid rules in the coming months. We are actively involved in that dialogue so please feel free to feedback any specific comments or fact patterns to us. As always, we are happy to discuss the above in further detail and please feel free to reach out to the PwC Ireland Alternative Investments Tax team for our assistance.

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