Keeping up with Alternative Investment Funds

September 2020

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Introduction

Welcome to our September edition of Keeping up with Alternative Investment Funds. Following the time of our previous edition, we are once again beginning to see the addition of more stringent lockdown measures by Government as 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 recent September client roundtable focused on the UK implementation of the Investment Firm Directive. Looking forward, our October client roundtable will look at what's on the tax landscape horizon with topics including potential tax changes in the UK Budget, the potential tax impacts of the US Presidential election and outlook for taxation across Europe.

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 September newsletter covers a wide variety of topics including Brexit update and broader workforce issues in light of COVID-19, as well as the review of Capital Gains Tax by the Office of Tax Simplification. Also, similar to our July edition, we have another overseas deep dive into areas that are topical in Luxembourg.

See the full list of articles in this newsletter below:

- Virtual workforce and permanent establishment risks for alternative investment funds
- Another look at VAT grouping
- Brexit Update
- Review of Capital Gains Tax by the Office of Tax Simplification, and other commentary
- Overseas Deep Dive – Luxembourg

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

David Selden joins PwC to head up new Alternative Investment Funds legal offering

PwC has appointed David Selden as partner to lead its AIF team's new legal business. David has joined PwC following 15 years, ten as partner, at US law firm Fried Frank. He brings experience of working on a variety of investment management and securities law matters across jurisdictions and asset classes, with emphasis on private investment vehicles, including hedge funds, private equity funds and real estate funds.

At PwC, David will provide the experience and credentials to support the firm in creating a new integrated tax, legal and regulatory service offering to AIF managers, investors and service providers as part of PwC's market leading tax team while working with PwC's NewLaw services business that provides managed legal services to a range of AIF clients globally.

We're thrilled to have someone of David's experience and expertise leading this new part of the business which will be a truly distinctive offering for a firm such as PwC. He also joins at a perfect time in the evolution of our global NewLaw Services offering and the support we are providing to existing AIF clients to technology enabled and deliver more efficient, cost effective legal services. We are extremely fortunate to have a hugely experienced partner moving from a market leading US fund formation specialist law firm to lead, build and develop this team.

Update on removal of Cayman Islands from EU tax haven blacklist

The removal of Cayman Islands from the EU tax haven blacklist is expected to be confirmed for October 2020, following EU's addition of Cayman Islands to the blacklist in February 2020. The timeline for the removal remains intact as the recommendation from the meeting of EU Code of Conduct Group will be discussed when EU Ministers of Finance meet in October to confirm whether the removal will be formally approved or not.

Based on the feedback from Cayman Government, Cayman has now implemented its new and amended investment funds legislation which sets out the framework for economic substance for Cayman based managers and is designed to address the EU's concerns that led to the blacklisting in February, including EU's primary concern over the timeframe within which the legislation was enacted. Therefore, it is expected that whether Cayman will be formally removed from the EU blacklist will be announced in October 2020.

Capital gains tax review

The Office for Tax Simplification has extended the deadline for detailed comments on the technical detail and practical operation of CGT to 9 November 2020. See article below for more detail.

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News Bulletin cont.

US's proposed carried interest regulations

On July 31, 2020, the Internal Revenue Service (IRS) published proposed regulations on the tax treatment of certain partnership interests which are held in connection with the performance of services, commonly known as the carried interest regulations. As background, due to the 2017 US tax reform, a new provision was introduced, IRC Section 1061, which increased the one-year holding period generally needed for long-term capital gain treatment to a greater than three-year holding period on the sale of applicable partnership interests and on partnership gain allocated to partners holding applicable partnership interests ("API"). The proposed regulations define certain key terms, describe the method for calculating the amounts subject to Section 1061, provide rules for applying Section 1061 through tiers of passthrough entities, detail the application of the exceptions to Section 1061, provide reporting rules, and describe rules for transfers to related parties. The proposed regulations generally apply beginning on or after the date final regulations are published in the Federal Register; however, taxpayers may rely on the proposed regulations for tax years beginning before final regulations are published. The proposed regulations provide that if a taxpayer chooses to rely on the proposed regulations, it must apply the regulations in their entirety. A further detailed discussion will be provided in a future edition.

Hong Kong's proposed carried interest concession

On 7 August 2020, the Hong Kong SAR Government released its proposal to provide a tax concession for carried interest for industry consultation. The consultation paper will provide a high-level summary of the proposed tax concession regime for carry. The detailed legislative provisions that govern the implementation of the regime will be contained in the tax amendment bill to be issued later on. The issuance of the consultation paper is timely and follows the various measures the government has already implemented to bolster Hong Kong's position as an international asset and wealth management centre, including the unified tax exemption ("UTE") for funds, introduction of the open-ended fund company regime, and the limited partnership fund regime.

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Virtual workforce and permanent establishment risks for alternative investment funds

Cross-border remote working

The current operating environment has shown that working remotely/virtually at scale is achievable, and for many employees, desirable. The transition to a "new normal", which includes a much more virtually enabled workforce, has raised a number of employment tax, corporate tax, indirect tax and HR issues and has triggered a wider discussion for organisations around how best to manage their globally mobile workforce going forward.

In particular, both the short term displacement of employees due to COVID-19 and the longer term trend towards remote working pose challenges for tax departments that need to manage the tax consequences of the flexibility that businesses want to offer to staff. One of the main risks we are currently evaluating with clients is whether a corporate taxable presence will be created through a permanent establishment ("PE") in the countries where remote workers are based. In its simplest form, this situation will arise where the remote working activities of an individual take place in a jurisdiction different from the individual's employing entity's country of residence. There is an added risk for those individuals that perform key investment management activities, whereby the funds they are managing could ultimately be at risk of having a taxable presence in the foreign jurisdiction.

Whilst remote working raises a number of issues that should be reviewed in more detail (e.g. value proposition to employees, employment tax, social security costs, legal, regulatory, etc), the remainder of this article focuses on: (i) the PE risks and how this should be evaluated in the context of cross-border remote working arrangements; (ii) the key medium- to long-term implications as remote working becomes the norm; and (iii) a high level overview of the VAT implications to be mindful of.

The permanent establishment risk

In brief, a PE is generally created through either (i) a fixed place of business; or (ii) a dependent agent. The rules seek to capture those situations where companies located in one territory undertake business activities in another country where they do not yet have a taxable presence. A PE is a taxable "nexus" that allows the local jurisdiction (i.e. the remote working location in this case) to tax a foreign entity (here, the employing entity, and, at the extreme, potentially the funds managed). Many countries have rules that determine when PEs are created and have incorporated these rules into domestic law and tax treaties. However, the rules are not uniform, exacerbating the complexity of managing an organisation's tax profile across jurisdictions.

The question of whether a taxable nexus is created hinges not only on the relevant tax rules, but it is also critically dependent on a wide range of commercial and operational factors. Key factors to consider include, the role of the individual (with particular sensitivity around those that perform key investment management activities), the degree of permanence of that individual in the foreign location, the ability to bind the company (for example, by making investment management decisions or agreeing investment terms with investors), and any other presence of the wider group in the foreign location (either directly through a taxable presence or by "fly-in" activities). If the conclusion is that a PE in the remote working location does exist, it will then be necessary to determine the taxable profits attributable to that PE.

Virtual workforce and permanent establishment risks for alternative investment funds cont.

The medium to long-term view

Tax authorities have recognised that PE outcomes will be different under the temporary conditions caused by COVID-19 (lockdowns, travel restrictions, quarantines). This exceptional situation has been acknowledged in guidance issued by the OECD, which influences tax policy in many countries, and by many individual tax authorities (including HMRC). However, this guidance is heavily focused on the exceptional and temporary nature of this displacement / remote working. The position will therefore change as lockdowns ease and travel restrictions are lifted.

Where people are working from jurisdictions other than their normal employment, the shift to remote working on a medium to long-term basis increases the possibility of a taxable nexus being created outside of the employing entity's jurisdiction. As remote working becomes the norm, the risk of creating a PE becomes more pronounced. In some cases, a PE may be created by the activities of as few as one or two individuals located outside of the country of their employing entity.

AIF managers will need to assess their specific medium to long-term positions in light of the role of the individuals and the activities undertaken abroad. AIF managers need to evaluate PE risks across the relevant spectrum of remote working options and functions (from back/middle-office through to front-office/strategic decision-making functions), with particular focus on key investment management and sales activities. Key investment management activities may create an ultimate risk for the funds, which requires AIF managers to be confident with their fund position on a trading versus investing analysis, being mindful that a large portion of the world does not have a "safe harbour" regime for non-resident funds like the UK's Investment Manager Exemption ("IME").

In some cases, AIF managers will want to assess and manage these risks up front. This may require an investment in systems or processes to be able to manage and respond to remote working requests in real time, as well as effective collaboration with the HR function. Others will be content to test their position after the fact: combining information on remote workers and business travellers, as well as reviewing data and time spent in countries to understand the overall risk profile of the business.

As noted, where a PE is created, AIF managers will need to consider the practical and administrative impact this will have - registering PEs, filing tax returns, establishing PE profit attribution policies, etc.

It is also important to address the business visa or work permit issues which can arise should someone commence to carry out their work duties in another country.

The VAT Lens

The rules in relation to what constitutes an 'establishment' for VAT purposes are slightly different to those rules used for direct taxes and need to be considered on a supply-by-supply basis. The VAT rules applicable in the context of supplies of services typically require a sufficiency of human and technical resources to make (or indeed receive) a supply, in order for an 'establishment' to exist.

When senior or key employees are working in a country which is different to their usual office location, it is necessary to understand what they are doing, and whether their presence in that country could potentially change the place of supply in relation to any of the activities in which they are involved. As noted, this could apply to supplies made by the business as well as supplies received by it.

During the ongoing disruption, many businesses have recognised just how much can be done outside regular office locations, which points towards a need to reconsider what human and technical resources are really required to create an establishment or fixed establishment for VAT purposes.

Virtual workforce and permanent establishment risks for alternative investment funds cont.

Another aspect for alternative investment fund managers to bear in mind in relation to VAT, in addition to the location(s) where the Management Company is established, is the location of its clients (e.g. funds) and where those are established for VAT purposes. To that end, what evidence is held to demonstrate that services are being received in the place where the fund is established (or resident). Similarly, where suppliers have key individuals working in locations which are different to their normal home countries, it may be necessary to review this in order to ensure that those suppliers are applying the correct VAT treatment to their supplies, as any VAT which is charged incorrectly may not be reclaimable.

Finally, there are other complicating factors in relation to establishments and place of supply issues. The recent European Court decision in Morgan Stanley, and the ongoing cases of Danske Bank and Bank of China, point towards the layers of complexity which can arise when individuals are working across international borders within a corporate structure. Moreover, the UK's departure from the European Union also remains a topic to closely monitor, particularly as the UK reconsiders its post-Brexit operating models to ensure that they are still fit for purpose, factoring in all of the COVID-19 related and operational changes that have occurred in the past months. The VAT compliance and VAT efficiency of such operating models are key considerations, as is the identification of potential problems areas so these can be addressed and mitigated as quickly as possible.

Next steps for alternative investment funds

The clear long term direction of travel towards a remote workforce in the future means that PE risks will become more prevalent and tax departments will need to develop protocols, systems and processes for dealing with a globally mobile workforce. Where the expectation is that remote working will become a long term operational structure, best practice recommendations are to ensure that:

1. Your organisation creates an operational framework and workflow tool to manage remote working requests;
2. The information on remote workers and business travellers is combined to understand the total risk profile of the business;
3. Ongoing management is implemented to review data around time spent in countries and decisions on risk mitigation are proactively made; and
4. Additional consideration is given to whether a change in location of people will have an impact on your VAT position.

These steps will help your organisation to understand whether a taxable presence (either direct or indirect) might need to be recognised in a remote working location; and help you start to prepare for increased tax authority scrutiny of both new and historic arrangements in which business documentation will be critical.

For a deeper discussion on how this may impact your organisation, get in touch with the authors or your normal PwC contact.

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Another look at VAT grouping

Introduction

Alternative Investment Fund managers might be aware that changes were made to the UK's VAT grouping rules on 1 November 2019, following a period of consultation by the government. The changes introduced at that time were relatively minor, and permitted certain non-corporate entities to join VAT groups in specific circumstances.

Now, less than 12 months later, a new call for evidence has been issued by the government into the way VAT grouping works in the UK. It is fair to say that some of the points raised in this new call for evidence are fundamental, and that the changes proposed could materially impact the way in which VAT grouping works in the UK.

It is therefore important for AIF managers to fully engage with this VAT grouping consultation, and to assess the potential impact and implications of these proposed changes to their VAT position and business operations.

A link to the call for evidence is below

'VAT Grouping - Establishment, Eligibility and Registration Call for Evidence'.

We have highlighted below some of the key points in the call for evidence. However, PwC will also be hosting an online seminar on 25th September to discuss this call for evidence in more detail. Information upon how to join the upcoming session is included at the foot of this article.

Limited Partnership and VAT groups

The part of this consultation that could potentially have the greatest impact to AIFs is the reference to VAT group membership eligibility criteria for both Limited Partnerships and Scottish Limited Partnerships (for ease referred to as "Limited Partnerships"). VAT Grouping is commonly used in the context of onshore UK Limited Partnership structures, subject to appropriate applications being made and with approval from HMRC.

The call for evidence questions whether Limited Partnerships should be allowed to be members of VAT groups. If provisions were to be introduced to limit the ability of Limited Partnerships to join a VAT group, this could have a direct and material impact upon certain UK fund structures. As such, we recommend AIFs with onshore Limited Partnership to look closely at the content of the consultation document.

Whilst such a move would seem incongruous with other recent consultations, which have considered how the UK could be made an attractive jurisdiction for investment funds, it is clearly an option under consideration.

The impact of any changes in this area could also extend beyond the VAT group membership of Limited Partnerships and therefore any such provisions would need to be very carefully assessed to understand how they could potentially impact other VAT group arrangements.

Cross-border entities and VAT groups

Certain financial services businesses have seen enquiries and challenges from HMRC in relation to the inclusion of fixed establishments of non-UK incorporated entities within UK VAT groups in recent years, and HMRC updated its Public Notice on VAT grouping (700/2) on 26 November 2019 to reflect its current policy in this area. Litigation is continuing in respect of some of HMRC's challenges.

The comments included in the Establishment section of the call for evidence refer to some of the outcomes from the current UK 'whole entity' approach to VAT grouping, and the call for evidence posits an alternative 'establishment only' approach to grouping. A move in this direction would, in principle, bring international branch - head office charges within the scope of the reverse charge where there is a VAT group in place and the recipient is in the UK (such charges ordinarily falling outside the scope of VAT at present). This would represent a fundamental change to the current position, and could increase significantly the amount of VAT cost for some businesses.

Another look at VAT grouping cont.

Compulsory VAT groups

The call for evidence notes that there are different forms of compulsory VAT grouping which apply in different EU Member States, and raises questions in relation to how this would impact UK businesses if introduced in the UK.

The UK VAT grouping provisions have always been on an elective basis, and have given businesses the freedom to form VAT groups and to add or remove members as required. This system requires applications to be filed, and there are anti-avoidance provisions in place to prevent abuse of the system.

A move to compulsory VAT grouping would require businesses to review the provisions enacting it, and then to undertake reviews of their group structures to identify any additional entities which would need to be brought into VAT groups. Businesses who have taken a selective approach to VAT grouping and have certain entities remaining outside of a VAT group may therefore be concerned about this prospect.

Next steps for alternative investment funds

From an initial review, if some of the points mentioned in the call for evidence are enacted, there could be wide ranging implications for AIFs. Accordingly, the AIF managers should review and monitor the call for evidence closely and assess any potential impact to their business operations.

The timing of this call for evidence may be questioned by some, falling against a backdrop of CJEU cases which have considered VAT groups and branch structures, the EU FS VAT review, as well as the ongoing UK litigation concerning VAT grouping (referred to earlier).
Many businesses are also in the midst of final preparations for Brexit, and further uncertainty in relation to how provisions of the UK VAT system will operate is likely to be unwelcome.

As noted, PwC will be examining the call for evidence in our online seminar on 25 September - joining details for the 25 September session are here

We will monitor the call for evidence as it develops, as well as any resultant VAT grouping changes, and provide updates in future editions of KUWAIF. However, if you would like to discuss this call for evidence in more detail or have any difficulties in registering for the online seminar on 25 September, please get in touch with Dan, Gabby or Neil (details below).

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Brexit Update

Brexit – Prepare to be flexible with contingency planning

Brexit is once again on the front pages as this month sees the final scheduled rounds of trade deal negotiations taking place with a view to any agreement being reached by mid-October.

Whilst a trade deal may still be agreed it looks like any form of equivalence assessment will only take place in 2021. Many alternative investment fund managers have substantially finalised or implemented internal restructuring or partnering with service providers to ensure they have the necessary regulatory permissions to continue their operations and to service clients in both the UK and the EU after the transition period ends on 31 December. AIFs and their managers should now be looking to ensure those plans are still fit for purpose and flexible enough to adapt to the range of potential outcomes including a No Deal Brexit.

Temporary permissions regimes

The Financial Conduct Authority ("FCA") have confirmed that they will be reopening the Temporary Permissions Regime ("TPR") notification window on 30 September. This will allow firms and fund managers that have not yet notified to do so before the end of the transition period. There will also be an opportunity for fund managers to update their previously submitted notifications, if necessary.

As a reminder, the TPR is designed to help firms and investment funds continue their UK business with minimal disruption when the passporting regime ends at the end of the transition period. It will allow EU27 based firms to continue operating in the UK within the scope of current permissions, covering existing and new business, for a limited period after the end of the transition period. During this time the firm can seek full UK authorisation, if required. It also allows AIFM's and other regulated firms marketing funds in the UK via a passport, to enter their funds into the temporary marketing permission regime ("TMPR") to allow marketing to continue in the UK for a temporary period.

Some EU27 member states introduced similar temporary rules to allow certain existing funds to continue to be sold cross-border in the event that the UK exited the EU without a deal. It will be crucial for firms who intended to rely on these rules to establish whether those that were announced in anticipation of a potential no-deal Brexit earlier this year will still be applied to a no trade deal or no equivalence scenario following the end of the transition period after 31 December 2020 (we have seen one such TPR being removed recently on the basis that UK managers have had enough time to plan under the transitional period as so the proposed TPR is redundant). These rules may offer solutions to market access on a temporary basis, but the long term post-Brexit cross-border market access for UK AIFMs in Europe remains unclear.

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Brexit Update cont.

Evolution of cross-border operating models

As examined elsewhere in this publication, the COVID-19 pandemic has resulted in unprecedented change to the working environment of the industry. Alternative investment fund managers should be considering whether this could entail significant changes to their cross-border operating models and working patterns. How will the ability to work remotely impact the requirements for people to perform certain regulated functions in certain jurisdictions? How will cross-border dual-hatting or secondment arrangements with third party AIFM's work in the event that travel restrictions continue beyond the short-term? How will the inability to meet in person impact the allocation of sales and client servicing teams on the ground in different jurisdictions? Will the development of technology provide solutions to such challenges that may result in long-term change?

Considering the unprecedented and unforeseen amount of change the pandemic has triggered, and changes to the industry and individual businesses since the EU referendum over four years ago in June 2016, the optimal cross-border operating model may look very different on 1 January 2021 to what may have been envisioned in early post-Brexit contingency planning.

Plans will need to be flexible and it will be essential to consider the wide range of potential tax implications in the event they are altered. These may include:

- Short term business visitor and local PAYE/payroll tax implications
- Social security implications
- Changes to VAT profile
- Changes to transfer pricing models and data
- Creation of new permanent establishments for the manager and perhaps, the AIF
- Movement of people, functions and assets, with potential UK exit charge and capital gains implications
- Work visas and work permits being required by travelling employees

Next steps for alternative investment funds

Prepare to be flexible with contingency plans and operating models to ensure they are adaptable to the range of potential outcomes for the cross-border regulatory environment following the end of the transition period, as well as long-term and permanent changes to working environment during and following the COVID-19 pandemic.

Ensure all necessary applications and registrations for the relevant temporary permissions regimes are made to enable the managers to operate and funds to be marketed cross-border on a temporary basis from 1 January 2021.

Where plans have already been finalised or implemented, firms should ensure they are thoroughly considering, documenting and accurately filing their position with respect to the tax implications of those plans.

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Review of Capital Gains Tax by the Office of Tax Simplification, and other commentary

Speculation continues to mount in the media around possible increases in UK tax rates, and how the government will fund the expenditure incurred in relation to COVID-19. There is no indication or confirmation as to what, if any, tax changes may come into effect. There is also no mention of a specific review of the tax rates on carried interest or co-investment.

Notwithstanding the above, the media has been highlighting the fact that the UK government has commissioned a number of general reviews into various aspects of the UK tax system, including capital gains tax (CGT). We have therefore summarised the current position as to what is being debated, partly in order that you have the opportunity to respond directly to the inquiries. If you wish so, please reach out to your normal PwC contact, or our personal tax specialists to discuss this further.

Office of Tax Simplification (OTS) – Capital Gains Tax

Following our article in last month's edition, you will note the office of tax simplification (OTS) has been asked by the Chancellor to look at CGT. The call for evidence comes in two sections. The first seeks high-level comments on the principles of CGT by 10 August 2020, while the second and primary section of the document invites more detailed comments on the technical detail and practical operation of CGT by 9 November 2020.

The review includes consideration of general areas such as:

- the overall scope of CGT and the various rates which can apply
- the reliefs, exemptions and allowances which can apply, and the treatment of losses
- the annual exempt amount and its interactions with other reliefs
- the position of individuals, partnerships and estates in administration
- the position of unincorporated businesses and stand-alone owner-managed trading or investment companies, including the setting up, selling or winding up of such businesses or companies
- any distortions to taxpayers' personal or business investment decisions
- interactions with other parts of the tax system such as Income Tax, Capital Allowances, Stamp Taxes and Inheritance Tax

The OTS review will also look at more specific areas of CGT such as administrative or technical issues relating to:

- clearance and claims procedures
- chargeable gains on shares and securities, including holdings of listed shares
- the acquisition and disposal of property
- the practical operation of principal private residence relief
- consideration of the issues arising from the boundary between income tax and capital gains tax in relation to employees
- valuations, record-keeping, calculating any tax payable and making returns, including claiming losses
- the information HMRC have and can use to help them reduce administrative burdens, improve customer experience and ensure compliance

The OTS wants to hear from individuals and businesses as well as professional advisers about which aspects of capital gains tax are particularly complex and hard to get right, and to hear any suggestions for improvements. PwC intends to engage with this consultation therefore we would be interested to hear any comments, concerns or observations that you might have.

The OTS, in addition to the call for evidence, also published an online survey so they can hear directly from individuals with experience of dealing with CGT. It is open now and can be found at the following link if you would like to participate.
https://www.smartsurvey.co.uk/s/3HRSVY/

Review of Capital Gains Tax by the Office of Tax Simplification, and other commentary cont.

Wealth Tax

There has been media coverage of a study that considers whether 'a UK wealth tax is desirable and deliverable', which is being undertaken by various specialists including economists, lawyers and accountants to consider all aspects of a wealth tax. As this is a matter of some public debate at the moment you may be interested in learning more about it, though we note the Government is yet to suggest that there will be a wealth tax.

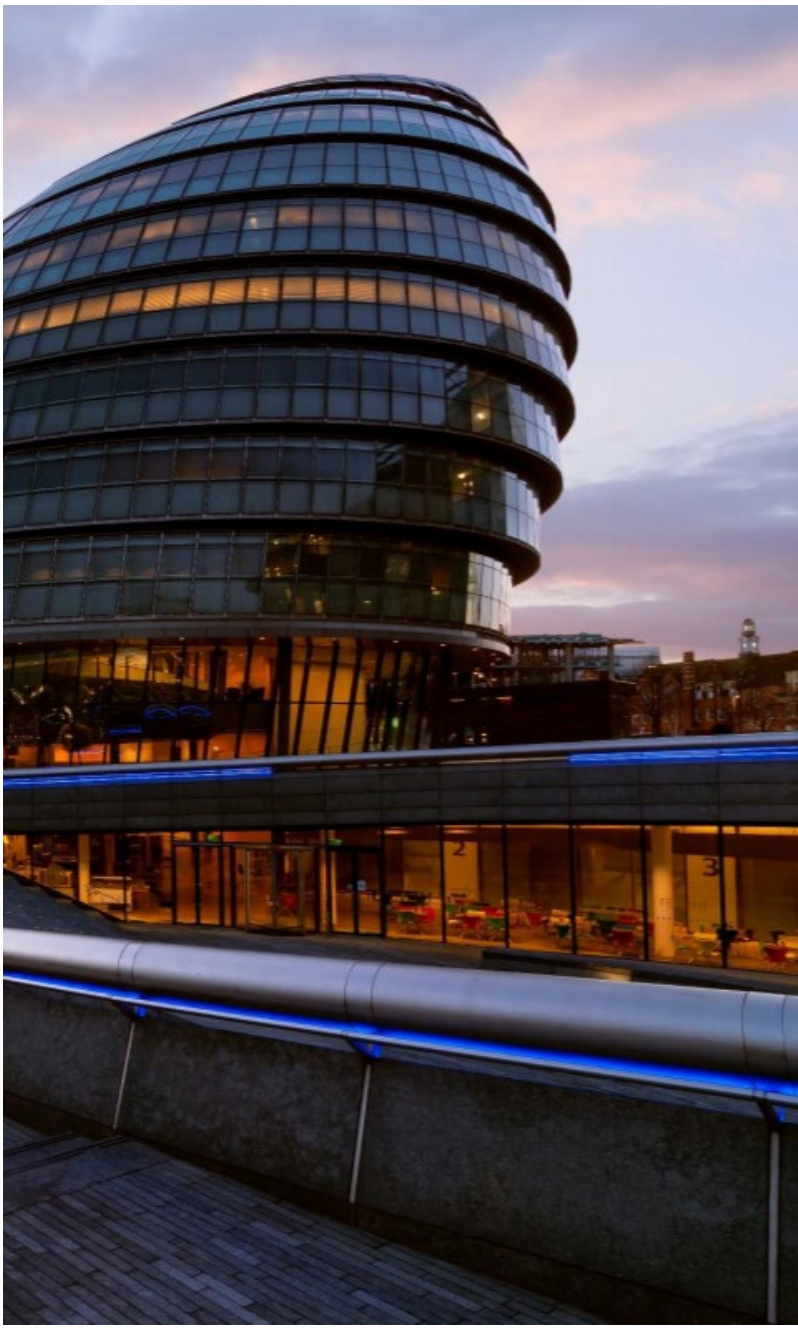
The study is intended to be placed in the context of the wide range of existing taxes on wealth in the UK; the initial wealth tax report highlights the issues that need to be considered in respect of a wealth tax and states:

'as we have outlined in this report, before it could be supported, let alone implemented, there are many questions that need answering. Who would pay it, and on what wealth? How would it affect incentives, for example to save and invest? How would we value assets? What mechanisms would be available for those who have low incomes relative to their wealth? How much revenue could it raise? How would it impact wealth inequality and the creation of wealth? Is there any need for a wealth tax in addition to existing taxes? And would the public support it? The aim of this project is to answer these questions'

Whilst the CGT review has been instigated by the Chancellor, no official Government review has been commissioned in respect of a wealth tax.

General review

Finally, the House of Commons Treasury Committee is also undertaking an inquiry on the problems inherent in our tax system and to identify areas that the government should focus on post the COVID-19 pandemic. We will provide further information on this once the inquiry has concluded.



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Overseas Deep Dive – Luxembourg

This month's contribution provides a high level overview of the industry in Luxembourg and the key Luxembourg structures considered by alternative asset investors. We also look at various tax regimes that the investor can benefit from to explain why Luxembourg has been a hub of European alternative investments.

Overview of the Luxembourg Alternative Investment Funds Industry

Luxembourg has been a hub for European investments for a long time. Due to various tax regimes and the number of available funds to choose from, the fund industry has shown a gradual expansion in terms of the number of funds and the size of funds (e.g. asset under management "AUM"). Luxembourg is the largest investment fund centre in Europe and the second largest in the world after the US, with EUR4.4 83 trillion in net assets under management (Source: Association of Luxembourg Fund Industry, May 2020).

In this particular section we want to highlight the fund vehicles that are commonly considered and being used by institutional investors - regulated funds (Specialised Investment Fund or "SIF" and Specialised Investment Company in Risk Capital or "SICAR") and unregulated funds (Reserved Alternative Investment Fund or "RAIF" and Special limited partnership or "SCSp").

Overall, the market for collective investment funds has been growing since the introduction of relevant laws. On the regulated fund side which includes undertakings of collective investment in transferable securities ("UCITS") and alternative investment funds, there are 3,749 funds with the AUM of EUR4,718.9billion as of December 2019 (Source: Commission de Surveillance du Secteur Financier).

With respect to the alternative investment funds that we are covering (i.e. SIF, SICAR, RAIF, and SCSp), there are a total of 1,458 SIFs with the AUM of EUR589million, and 249 SICARs with the AUM of EUR55million as of December 2019. On the other side, there are 906 RAIFs and 3,416 active/registered SCSps as of December 2019 (Source: Commission de Surveillance du Secteur Financier).

Based on our internal statistics using the sampling analysis, we understand that, in terms of the alternative investments, the regulated funds (91%) were more preferred than the unregulated funds (9%). In terms of the asset classes, we noted that 48% of funds are investing in private equity, where 27% are investing in real estate. Private debt follows next with 14% and, finally, 11% invests in infrastructure (Source: PwC analysis).

As the above figures demonstrate - apart from political and economic stability, engaged government and regulators, centrally located in Europe/close proximity to assets, supportive legal and regulatory frameworks - Luxembourg has successfully played a role as an entry gate to investors from Europe and outside of Europe.

Popular Luxembourg structures for alternative investments

A) Supervised vehicles

1. Specialised Investment Fund (SIF)

Since its entry into force in 2007, the SIF law has clearly demonstrated that it enables tailored solutions responding to the industry's needs. The increase in respect of numbers of SIFs and their AUM demonstrates the high acceptance by the market players. Combining Luxembourg's extensive know-how in fund regulation with the ability to invest in alternative assets, SIFs are lightly regulated and reserved to well-informed investors. SIFs which qualify as Alternative Investment Funds ("AIF") under the Alternative Investment Fund Manager Directive ("AIFMD") must be managed by an authorised Alternative Investment Fund Manager ("AIFM"). The SIF law does not provide for specific investment rules or restrictions; however, SIFs are subject to the principle of risk spreading, and must be authorised by the Luxembourg supervisory authority for the financial sector (Commission de surveillance du secteur financier or "CSSF") prior to commencing their operations.

A SIF may be set up under a contractual form (FCP - common fund), or as an investment company with variable capital ("SICAV") or fixed capital ("SICAF") opting for any of the various legal forms provided for in the Luxembourg Company Law (e.g. public limited company, private limited company, limited partnership, special limited partnership, partnership limited by shares), and may be structured as a stand-alone vehicle or as an umbrella vehicle with multiple compartments having segregated assets and liabilities. In such a case, the rights and obligations of investors and of creditors concerning a compartment are limited to the assets of that compartment, and each compartment may be separately liquidated without such separate liquidation resulting in the liquidation of another compartment. Only the liquidation of the last remaining compartment will result in the liquidation of the SIF.

Overseas Deep Dive – Luxembourg cont.

SIFs are normally subject to a 0.01% subscription tax and are not subject to any other Luxembourg taxes (i.e. Corporate Income Tax ("CIT"), Municipal Business Tax ("MBT") as well as Net Wealth Tax ("NWT")).

Distributions made out of SIFs are free of withholding tax in Luxembourg and capital gains realised by non-resident investors are not taxed in Luxembourg.

2. Investment Company in Risk Capital (SICAR)

The investment company in risk capital (société d'investissement en capital à risque or "SICAR") was introduced into Luxembourg Law in 2004. Specifically dedicated to private equity and venture capital investments, the SICAR is a vehicle whose purpose is to invest in securities representing "risk capital". This notion is characterised by the high risk inherent in portfolio investment and the intention to develop the target entities. SICARs are subject to the permanent supervision of the Luxembourg CSSF and must be authorised by the latter prior to commencing their operations. SICARs which qualify as AIFs must appoint an AIFM. The SICAR law does not impose any risk spreading requirements. Investments are restricted to well-informed investors.

A SICAR may be set up as a SICAV or SICAF and in the same manner as for SIFs, it may be constituted with multiple compartments, with each compartment corresponding to a distinct part of its assets and liabilities.

While SICARs in the form of an SCS or an SCSp are fully transparent for Luxembourg tax purposes, a SICAR set up under a corporate form is subject to Luxembourg CIT and MBT on its worldwide profits at ordinary rates and thus qualify as a resident for Luxembourg's tax treaties. However, any income derived from securities (whether in the form of interest, dividend or capital gains) that represent risk capital in the meaning of the SICAR law are fully exempt from CIT and MBT. Income derived from funds held pending their investment in risk capital are also exempt from CIT and MBT provided the funds are invested within 12 months. SICARs established under a corporate form are subject to a minimum NWT of EUR 4,815.

Dividend distributions made by a SICAR are not subject to withholding tax in Luxembourg.

B) Unsupervised vehicles

1. Reserved Alternative Investment Fund (RAIF)

Introduced into Luxembourg Law in 2016, the Reserved Alternative Investment Fund ("RAIF") has changed the Luxembourg AIF landscape. The RAIF regime is based on the SIF and the SICAR regimes. However, unlike SIFs and SICARs, a RAIF is not required to obtain clearance from the CSSF before launch and does not fall under the direct ongoing supervision of the CSSF, which makes it a flexible multipurpose AIF that can be marketed quickly. As a RAIF qualifies as an AIF, it is only regulated through its relevant manager, under the AIFMD. In the same manner as for SIFs and SICARs, investments into RAIFs are restricted to well-informed investors. No limitation applies as regards to eligible assets or investments policies, however, it is subject to risk diversification requirements in principle, unless it has opted for the SICAR regime (i.e. its constitutive documents restricts its investment policy to investment in risk capital only).

A RAIF may be set up as a common fund or as a SICAV/SICAF under one of the various legal forms available into Luxembourg company law and it may be constituted with multiple compartments.

RAIFs are normally subject to a tax regime similar to that of a SIF. They are subject to a 0.01% subscription tax and are exempt from any other Luxembourg taxes (i.e. CIT, MBT as well as NWT).

By exception, RAIFs that invest exclusively into risk capital related securities may opt for a tax regime similar to the tax regime of a SICAR (i.e. taxable for CIT and MBT, but with a wide exemption for income related to risk capital securities). Under this option, RAIFs are subject to the minimum NWT. The combination of these two different tax regimes should not be possible within the same legal entity having different compartments.

Distributions made out of RAIFs are free of withholding tax in Luxembourg and capital gains realised by non-resident investors are not taxed in Luxembourg.

Overseas Deep Dive – Luxembourg cont.

2. Special limited partnership (SCSp)

The Luxembourg special limited partnership (Société en Commandite Spéciale, or "SCSp") was introduced in 2013 as one of several measures designed to encourage the AIF in Luxembourg. The SCSp has filled a notable gap in the range of legal entities offered in Luxembourg. In contrast to the long-established standard Luxembourg limited partnership (Société en Commandite Simple, or "SCS"), a SCSp does not have a legal personality separate from those of its partners. It allows for more flexible structuring when compared with SCSs and other corporate entities established in Luxembourg, which must comply with additional corporate law requirements. It is formed by a limited partnership agreement ("LPA") approved and signed by all general and limited partners.

The SCSp is a multi-purpose vehicle that aims to extend the range of legal solutions available in Luxembourg for structuring both alternative investment funds, and dedicated vehicles to the alternative investment industry. It may be used as an unregulated fund vehicle not supervised by the CSSF. In such case, it can benefit from the AIFMD marketing passport provided it qualifies as an AIF under the AIFMD and appoints an AIFM. A Luxembourg SCSp may also be considered as a suitable form for a feeder fund vehicle, set up to accommodate investment into the fund by one or more investors who have particular needs or obligations not shared by all of the target investors for the fund, or to "ring-fence" investors who might otherwise cause all the investors to suffer additional costs, such as those of tax or regulatory compliance, or of an undue disadvantageous tax treatment. The contractual flexibility of the SCSp regime can also favour the use of an SCSp as a co-investment vehicle, typically formed to accommodate investments by one or more investors on a deal-by-deal basis. More recently the SCSp has become a popular legal form for the setting up of the carried interest structures through which the fund's sponsor/key executive managers may derive a priority or enhanced share of the profits of a fund.

An SCSp is not deemed to have a tax personality separate from that of its partners. Accordingly, it is treated as a tax transparent entity not subject to CIT and NWT in its own name. An SCSp remains subject to MBT on its profits if it carries out a business activity or if its general partner is a Luxembourg limited liability company owning at least 5% of the partnership interest in the SCSp. However, SCSp qualifying as an AIF within the meaning of the AIFM Act is not deemed to carry out a commercial activity and therefore will only be subject to MBT if its general partner is a Luxembourg limited liability company owning at least 5% of the partnership interest in the SCSp (which is usually not the case).

No withholding tax applies in Luxembourg on distributions made by a SCSp.

Overseas Deep Dive – Luxembourg cont.

Other key tax considerations

Tax treaty network

Luxembourg has a dynamic and open economy which actively promotes the development of cross border trade and investments. Its major role in terms of international trade in the sectors of banking and finance, investment funds and holding companies is as a result of the strong network of double tax treaties has been developed over the years. To that end, Luxembourg has entered into more than 80 comprehensive double tax treaties based on the OECD model tax convention on income and capital in order to mitigate the risks of double taxation for businesses.

Multilateral Instrument ("MLI") and the Principal Purpose Test ("PPT")

In 2017, Luxembourg was one of the original 68 jurisdictions to sign the OECD-sponsored Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS – commonly referred to as the "Multilateral Convention" or "MLI". Since then, Luxembourg has completed all the necessary steps to ratify the MLI.

Following this, on 9 April 2019 Luxembourg deposited with the OECD its instrument of ratification of the MLI. Under the provisions of the MLI, this formal action defines the subsequent timing for the MLI to begin to come into effect for Luxembourg's network of tax treaties.

The MLI has now formally "entered into force" Luxembourg from 1 August 2019.

The dates on which the provisions of the MLI that apply to Luxembourg's double tax treaty network then actually come into effect are variable, as these also depend on the timing of the ratification process for the MLI by each relevant treaty co-signatory. However, it is now clear that, insofar as the new "Principal Purposes Test" in the MLI potentially limits the treaty benefits of reduced or zero rates of withholding taxes, for many of Luxembourg's treaties these MLI measures have taken effect on 1 January 2020.

Participation exemption

Luxembourg's participation exemption regime provides for an exemption from income, withholding and NWT for qualifying investments held by qualifying entities. The exemption from income tax is extensive, covering dividends, capital gains and liquidation proceeds. In addition, no withholding tax applies on dividend distributions if the conditions for the participation exemption are met. Finally, participants qualifying for the participation exemption are exempt from NWT.

The Luxembourg participation exemption regime has been amended in order to introduce anti 'hybrid instruments' and general anti-abuse rules ("GAAR") rules derived from the amended EU Parent/Subsidiary Directive. These provisions apply to income distributed or received after 31 December 2015.

The GAAR precludes Directive based benefits whenever there are any arrangements that, having been put into place with a main purpose of obtaining a tax advantage that defeats the objective or purpose of the Directive, are 'not genuine'. A 'not genuine' determination should be based on all relevant facts and circumstances. Under GAAR, an arrangement should be considered 'not genuine' insofar as it was not structured for 'valid commercial reasons that reflect economic reality'.

The Luxembourg tax authorities have not provided any substantive guidance or interpretation of these EU driven measures.

Finally, it is important to note that a recapture system exists wherein the capital gain realised will become taxable up to the amount of the aggregate expenses and write-downs in relation to the participation deducted during the year of realisation of the exempt capital gain and in previous years.

ATAD I & ATAD II

The Council Directive (EU) 2016/1164 ("ATAD I") has been transposed into Luxembourg law, with effect from 1 January 2019. The law notably includes Luxembourg interest deductibility restrictions, exit taxation rules for certain cross-border transfers of assets or residence within the EU or to non-EU countries, General Anti-Avoidance Rules, Controlled Foreign Corporation rules, which will apply to both EU and non-EU situations, to avoid the transfer of passive income to low taxed jurisdictions and hybrid mismatches for transactions with EU parties. Some guidelines from the Luxembourg tax authorities on interpretation of the interest limitation rules are expected in the coming months.

Overseas Deep Dive – Luxembourg cont.

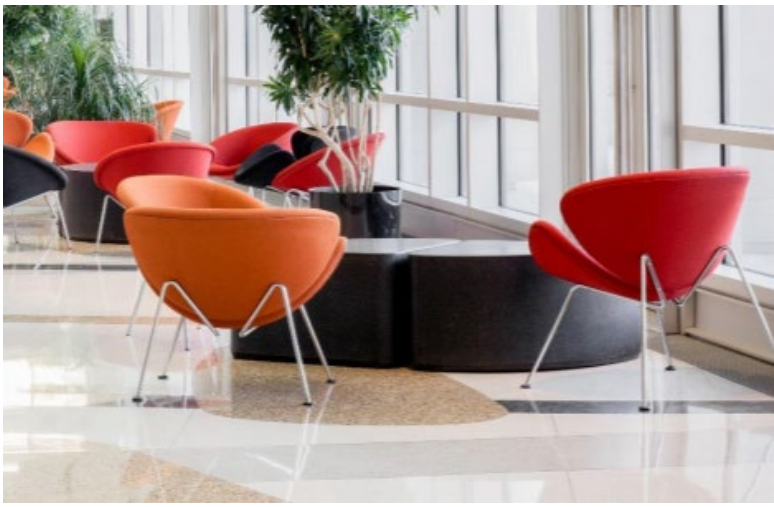
The Council Directive (EU) 2017/952 amending ATAD I ("ATAD II"), transposed into Luxembourg law with effect as from 1 January 2020, introduces Luxembourg new anti-hybrids rules with non-EU parties. More specifically, the law covers hybrid instrument mismatches, hybrid entities mismatches, hybrid permanent establishment mismatches, hybrid transfers, imported mismatches, reverse hybrids and dual resident mismatches. Reverse hybrid rules included in the law will take effect as of 1 January 2022.

DAC 6

On 21 March 2020, the Luxembourg Parliament voted to approve the Bill implementing the Directive (EU) 2018/822 on mandatory exchange of information in the field of taxation in relation to reportable cross-border arrangements (commonly referred to as "DAC 6"). Cross-border arrangements may be reportable if they meet at least one of the "hallmarks" listed in the law. Some of these "hallmarks" only have to be considered if they also meet the so-called "main benefit test". Following the European Commission's proposals to defer deadlines for automatic exchange of information regimes and the agreement reached on 3 June 2020 at the level of the Permanent Representatives Committee, the Luxembourg Government voted for a Bill on 24 July 2020 which extends the deadlines for the communication and exchange of information provided for in the DAC 6 law by 6 months: information on reportable cross-border arrangements from the period 25 June 2018 – 30 June 2020 shall be reported by 28 February 2021 while the 30-day reporting period for cross-border arrangement that becomes reportable on or after 1 July 2020 shall begin on 1 January 2021 .

Measures applicable for the EU blacklist countries

On 30 March 2020, the Luxembourg Government tabled a Bill before the Luxembourg Parliament, setting out draft legislation aiming to deny the tax deduction of interest or royalties payments made to associated enterprises established in EU blacklisted territories. Under the draft law, the non-deductibility is foreseen for interest and royalties paid or accrued as from 1 January 2021 onwards to beneficial owners which, cumulatively, have a corporate form from a Luxembourg tax perspective, are related party to the Luxembourg taxpayer and are established in a country which is on the EU blacklist (with first application proposed based on the list as of 1 January 2021). However, the payment would remain deductible if the Luxembourg taxpayer can prove that the transaction that leads to the payment has valid commercial reasons that reflect an economic reality. Luxembourg companies having transactions with entities established in jurisdictions that are currently on the EU "blacklist" will need to assess their situation, recognising that the composition of the list might change, notably during the remaining months of 2020.



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