Keeping up with Alternative Investment Funds

November 2020

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Introduction

Welcome to our November edition of Keeping up with Alternative Investment Funds.

As we move into winter, we have seen former Vice President Biden win the US elections, followed by positive news on development of the first effective COVID-19 vaccines. Beyond the pandemic and US presidential elections, with Brexit trade talks again brought to a standstill, and it a near certainty that asset management will not be covered by any trade deal; it is ever important for firms to persist with efforts to prepare for the end of the transition period in December. As always, we hope you and your families continue to remain safe and well in these uncertain times.

To support organisations with their response to the ongoing impact of the Covid-19 pandemic, our **COVID-19 website** will continue to feature 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.

Over November and December we will be holding more targeted client virtual roundtables to allow smaller client communities to network and discuss common issues, allowing for a more focused session and a deeper dive into the discussion points. The dates for the November/December series of virtual roundtable events are set out below:

Private Credit - 24 November - 08:30 - 09:30 GMT
Private Equity - 1 December - 08:30 - 09:30 GMT
Real Assets - 2 December - 08:30 - 09:30 GMT
Liquid trading - 3 December - 13:00 - 14:00 GMT

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 November newsletter covers a wide variety of topics including an update on the US election and Brexit.

See the full list of articles in this newsletter below:

- Brexit: Prepare to be flexible with contingency planning
- US tax update and US elections
- Sustainable Finance Disclosures Regulations for AIFMs
- The impact of the investment Firms Regime and the Investment Firms Prudential regime on remunerations
- Operational transfer pricing: Beyond transfer pricing policy and strategy, building sustainable transfer pricing implementation
- Virtual workforce permanent establishment risks for Alternative Investment Funds
- Cyber Security: A growing threat for Alternative Investment Funds

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

Capital Gains Tax Review by the Office of Tax Simplification (OTS) and other comment on Wealth / Individual Taxation in the Current Environment

As you will be aware there is continued discussions about how the Government will fund the increasing expenditure in relation to Covid-19, including whether the current tax system will be reformed.

There are a number of different reviews being undertaken and many wider economic and political areas to be considered, but the key points are:

1 - The OTS published their first review of CGT this week.

The recommendations in that report covered:

Rates and boundaries of CGT and income tax, i.e. whether tax rates should be aligned or should the Government address the boundary issues between what is a capital gain and what is income,

The role of the CGT annual exempt amount, Capital transfers and interaction between CGT and inheritance tax (IHT), and Business reliefs including recommending replacing Business Asset Disposal Relief (formerly Entrepreneurs' Relief) with a relief more focused on retirement.

It is not clear when any decisions on these four policy areas will be made by the Government but we would potentially expect to hear more in the next Budget (the date of which has not yet been announced but which is currently expected in March). In addition, you may recall that a similar review was undertaken by the OTS in respect of Inheritance Tax (IHT). As yet no changes have been made to IHT following this review, however this is not to say that change will not happen in the future.

2 - Wealth Tax

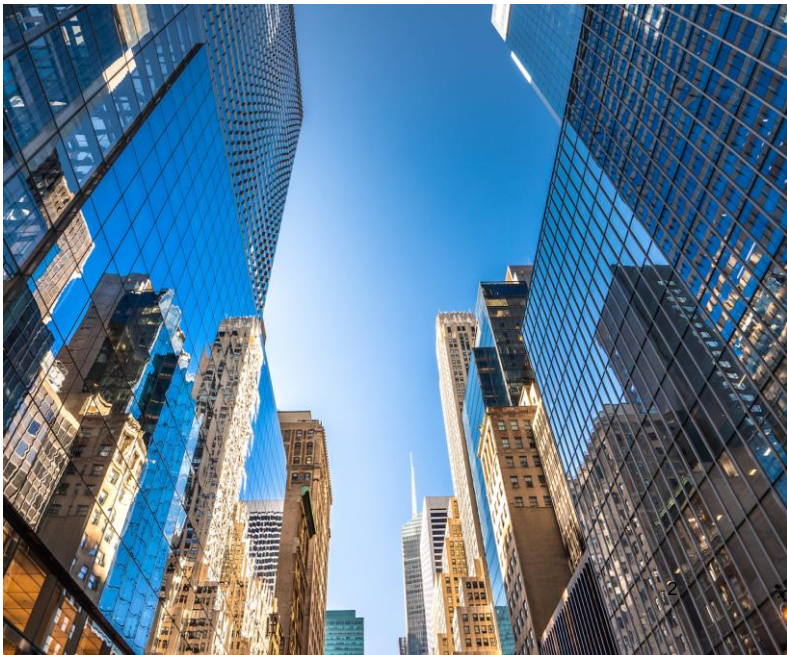
There has been media coverage of a project being funded by the London School of Economics (LSE) COVID-19 Rapid-Response Fund; the LSE International Inequalities Institute (by a grant from the Atlantic Philanthropies Foundation); and CAGE Warwick which is considering whether 'a UK wealth tax is desirable and deliverable'. The study is being undertaken by various specialists including economists, lawyers and accountants to consider all aspects of a wealth tax.

In addition the Wealth Tax Commission has recently published evidence papers which highlight the key issues in the principles and practice of designing a wealth tax, including valuation, design issues with defining the tax base and the issues for individuals who are asset rich but cash poor.

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

Summary

It is not possible to predict what changes may or may not come as a result of these reviews and clearly caution should be advised given the uncertainty. Nonetheless it may be timely to consider your current circumstances taking into account a wide range of factors including personal and commercial objectives, asset protection, succession, future investment plans and cash flow needs, alongside the impact of the tax regime.



News Bulletin cont.

Spanish Finance Bill 2021

The Spanish government recently published the finance bill for 2021 that it had submitted to parliament for consideration.

Some highlights below from initial review of the bill, we will share a more detailed news alert once available. The new 95% cap on participation exemption would be particularly relevant for Spanish holdings in multi-tier structures.

From a market perspective, it is worth highlighting that the bill identifies infrastructure investments as a strategic objective for Spain's economic recovery. The government proposes to allocate c.€6bn to infrastructure (including EU funding).

95% cap on participation exemption

The bill reflects the previously proposed 95% cap on participation exemption for dividends and capital gains (foreign and domestic, including within a Spanish tax group). This would result in 1.25% effective tax for companies subject to the standard 25% rate.

This would be relevant both for inbound investments (e.g. tax leakage at each level of multi-tiered structures) and outbound structures with Spanish holdings such as ETVEs.

The cap would apply to fiscal years starting after 1 January 2021 which have not concluded when the law comes into force.

There is a grandfathering provision allowing 100% participation exemption on dividends up to 3 years from incorporation of qualifying subsidiaries. However the scope is rather limited and would effectively exclude existing structures (e.g. the Spanish parent needs to have turnover below €40m in the previous year; the subsidiary has to be incorporated after 1 January 2021, and be 100% directly owned by the parent since its incorporation; the parent cannot be part of a group under Spanish law or hold other significant stakes before incorporation of the qualifying subsidiary).

Alternative minimum €20m cost of shares for minority investments

Under current Spanish law, a minimum €20m cost of acquisition of shares can be substituted for the minimum 5% shareholding otherwise required by participation exemption or 0% dividend WHT under the EU Parent / Subsidiary Directive.

The bill eliminates this alternative for shares acquired from 1 January 2021 onwards. For shares already held before 1 January 2021, the minimum €20m cost would qualify for the purpose of participation exemption and 0% WHT up to and including FY25.

Spanish REITs (SOCIMIs)

The Spanish government has confirmed that it is planning to introduce a 15% tax on undistributed profits of SOCIMIs. This is not part of the finance bill.

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Brexit: Prepare to be flexible with contingency planning

Brexit is once again on the front pages this month. Whilst a trade deal may still be agreed the possibility of mutual equivalence determinations looks very remote (the UK has made such a determination in the last week). Many AIF Managers have substantially finalised or implemented internal restructuring plans or have partnered with 3rd Party Manco 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. AIF Managers should now be looking to ensure those plans are still fit for purpose and should ensure that they now focus on the detailed implementation of those plans.

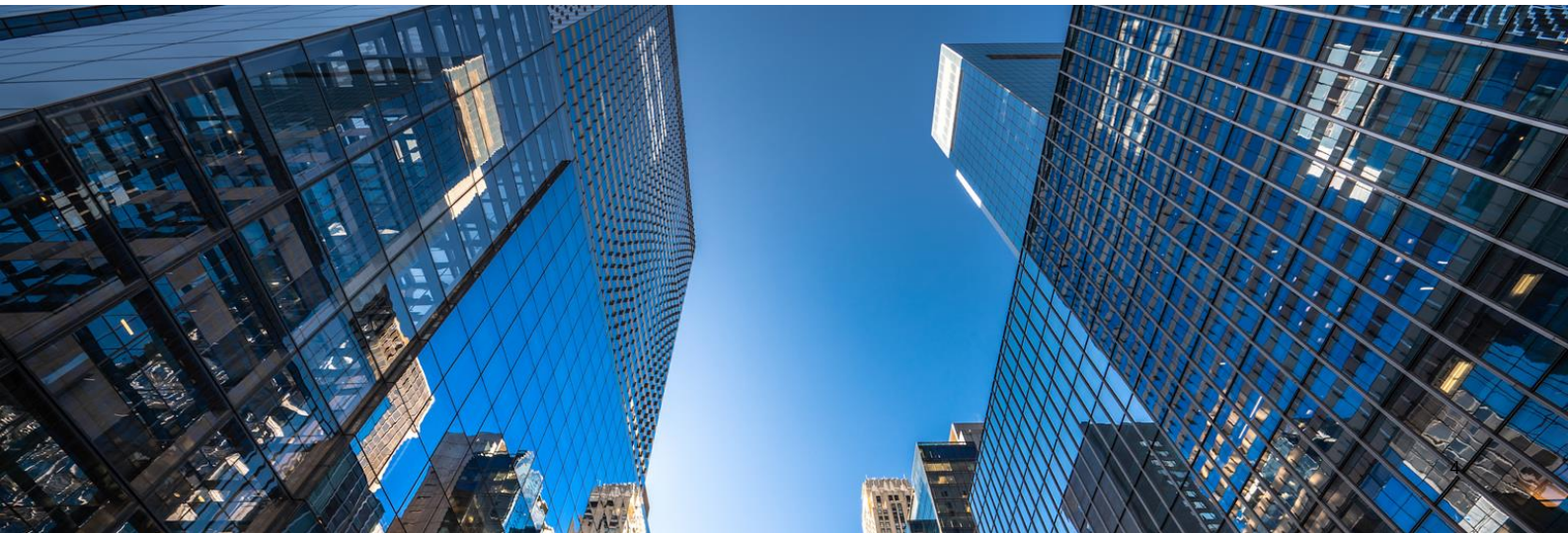
Temporary permissions regimes

The Financial Conduct Authority ('FCA') reopened the Temporary Permissions Regime ('TPR') notification window on 30 September. This allows fund managers that have not yet registered to distribute funds into the UK or to manage UK funds to do so before the end of the transition period. There also 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 on 31st December 2020. It will allow EU27 based firms to continue operating in the UK within the scope of current permissions, covering existing and new business, for up to five years after the end of the transition period. During this time the firm can seek full UK authorisation, if required. It also allows AIF Managers 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 on 30 January 2020. 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 on 30 January 2020 will still be applied to a no trade deal or no equivalence scenario following the end of the transition period after 31 December 2020 (for example the Netherlands have recently withdrawn their TPR for segregated mandates management). These rules may offer solutions to market access on a temporary basis, but the long term post-Brexit cross-border market access for Alternative Investment Funds in Europe remains unclear.

Evolution of cross-border operating models

The COVID-19 pandemic has resulted in unprecedented change to the working environment of the industry. AIF 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 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.



Brexit: Prepare to be flexible with contingency planning cont'd

We have seen a recent significant increase in AIF managers, particularly US in-bound clients looking to use 3rd Party Mancos to support their European sales and to provide MIFID air cover for trade and execution activities. There are a multitude of different sales and distribution offerings in this market, such as secondments, chaperoning, out-source marketing and tied agent structures; with jurisdictions such as Portugal, Malta and Cyprus being used. Some of these structures present complex tax, legal and regulatory challenges and interactions once you dive into detailed implementation.

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
- Creation of new permanent establishments
- 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 manager 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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US tax update and US elections

Former Vice President Biden is projected to have won the White House, but at the time of writing final results have not been certified and Trump campaign officials are contesting the results. Control of Congress is key to the outlook for action on Biden's tax proposals, but control of the Senate will not be decided until January. This article provides an overview of the key Democratic business and individual tax changes proposed and an update on recently released carried interest regulations.

Of most importance to the alternatives industry is the potential for across the board tax increases, including an increase in the corporate and individual income tax rates, increase of tax on businesses and as well as an increase in the US tax rate applicable to the foreign earnings of US persons (i.e.GILTI). Additionally, there will also be increased focus on how Biden addresses certain provisions from the 2017 tax reform that either expire or change over the next few years (including interest deduction limitations and increase in individual tax rates).

In addition to the election, alternative investment managers must also pay careful attention to the myriad of Regulations, proposed and / or final, which the Treasury have released during the course of 2020 (including regulations on taxation on carried interest, withholding on sale of certain partnership interests, anti-hybrid provisions, interest deductibility, and foreign tax credits) which may impact important facets of the alternatives business model.

This article will only focus on the carried interest regulations, however alternative investment managers ("foreign alternative investment managers", "alternative investment managers") should also consider the impact of the other recently introduced regulations.

US Elections and tax policy update

During the course of their campaign, Democratic President elect Joe Biden and Vice President elect Kamala Harris ("**team Biden", "Biden")** released a fact sheet containing tax proposals with the goal of developing a tax regime that both encourages and increases domestic production. The backbone of the campaign has been a vow to increase taxes on corporations and the wealthy. However and given the current economic environment, the measures ultimately introduced are likely to be impacted by the high unemployment figures, record government debt, and as well as another potential Covid-19 response package which is expected to be the first major first initiative of the Biden presidency.

Tax Rate increase

The Tax Cuts and Jobs Act ("TCJA") reduced the corporate tax rate to 21% for tax years beginning after December 31, 2017. The combination of a lower corporate tax rate and policies taxing foreign profits at a minimum rate, truly set the TCJA apart from its predecessors. In contrast, team Biden proposes to increase the tax rate to 28% and the below graph depicts how the tax rate of the U.S. is likely to compare to those of other countries, should this proposal be adopted.

Needless to say, an increase in corporate income tax is likely to have an impact on US inbound alternative investment managers and fund structure.

Specifically and even though most portfolio managers and funds typically have flow through structures, there are corporate entities in the fund structures (whether as blockers to block unrelated business taxable income or effectively connected income) or at the level of the portfolio company . As such, the corporate tax rate increase to 28% is likely to have an impact on the ETR of a deal. As a result, it could also lead to companies moving their headquarters to jurisdictions with lower corporate tax rates.

US tax update and US elections cont'd

There is also a proposal to introduce a minimum alternative tax which will be applicable on entities which have book income of over a 100 million dollars.

In the financial market setting, there may be blockers corporations which could have this level of book income and this might again impact the effective rate of return on investments.

In addition to business tax proposals that apply generally, Biden also proposes to institute a financial fee on certain liabilities of large financial institutions with over $50 billion in assets.

Another key change, as discussed in the next section, is the increased taxation of international operations through changes proposed in relation to the Global intangible low-taxed income regime ("GILTI").

Anti-Base Erosion Regime

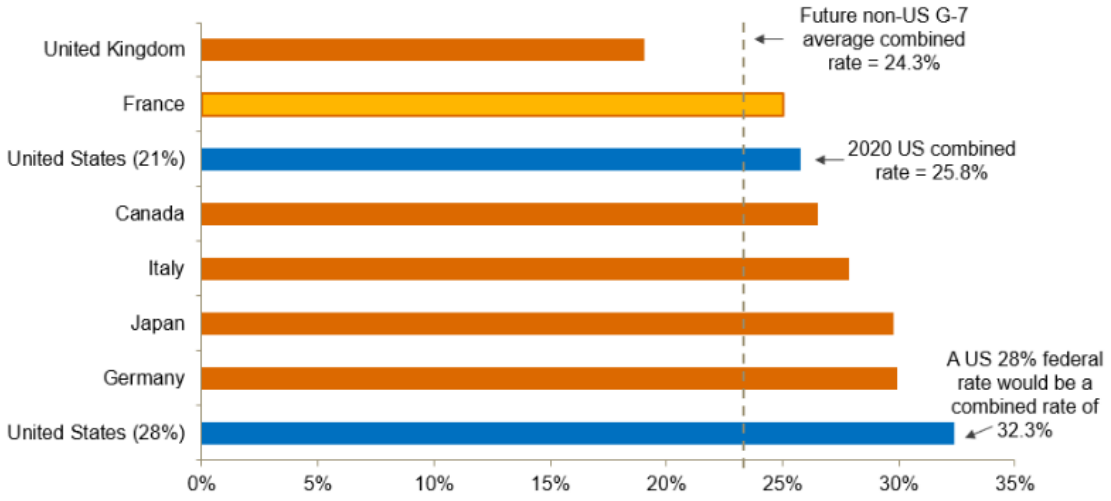
Team Biden seeks to change the minimum tax policy currently applicable to foreign profits of U.S. companies. The intention of the GILTI regime was to discourage companies from using intellectual property to shift profits from the United States to other jurisdictions with lower tax rates.

Companies are currently required to pay a tax of at least 10.5% on foreign income generated from relatively mobile and intangible assets held abroad such as patents, trademarks, and copyrights. This tax is determined based on 50% of the current income tax rate at 21%. An increase in corporate tax rate to 28% would double the GILTI tax to at least 14% (before 2026).

Additionally, team Biden proposes to increase minimum tax on profits earned by foreign subsidiaries of US firms from 10.5% to 21%. In a notable departure from Trump's plan, team Biden is now also proposing to change the calculation to a country-by-country minimum tax, instead of calculating all of the earnings of a US shareholder's controlled foreign corporations in the aggregate.

Lastly, team Biden also proposes to eliminate the 10% Qualified Business Asset Investment ("QBAI") exception to GILTI. QBAI constitutes the fixed assets of a foreign subsidiary, with U.S. tax depreciation taken into account. Currently, GILTI income includes any foreign income that exceeds 10% of a foreign subsidiary's QBAI.

However, additional provisions of the team Biden's platform include other measures designed to discourage offshoring of production and services, as well as incentivise the onshoring of jobs.



US tax update and US elections

Other key changes

Other than the individual personal tax rates going back to where they were prior to the tax reform i.e. to 39.6%, the other significant proposal from team Biden is the removal of preferential long term capital gains tax rate and qualified dividend income treatment for individuals who make over a million dollars. This would have a significant impact on hedge fund managers, private equity managers. The other proposal of significance is eliminating the cap on social security tax (much like the NIIT tax), which would increase the effective tax rate payable by managers (depending on the state of residency).

There are other Democratic proposals that could affect the financial services sector, such as introducing the mark-to-market regime to limit capital gains deferral for certain high-income individuals. During his tenure, President Obama had also proposed taxing investment fund partnership carried interest as ordinary income, which as discussed in the next section, is currently not included in the proposed regulations but could very well be revived under the government.

The Future of Carried Interest

In this section, we will touch upon the recently introduced proposed regulations on carried interest (Section 1061). Perhaps most notably, Section 1061 limits the eligibility of holders of applicable partnership interests to avail themselves of preferential long-term capital gains rates, by increasing the original holding period requirement of greater than one year to greater than three years. The Proposed Regulations provide insight into a variety of areas that were left open to interpretation since the enactment of the initial law in 2017. Furthermore, while Section 1061 applies to taxable years beginning after December 31, 2017, the Proposed Regulations will not be in effect until final regulations are published, and may be modified in whole or in part as the IRS considers comments from stakeholders.

For instance, post-tax reform, there has been uncertainty surrounding the application of the carried interest rules to passive foreign investment companies (“PFICs”). Due to this ambiguity, a simple QEF election could allow gains received from a PFIC to avoid recharacterisation under Section 1061. The Proposed Regulations specifically provide that PFICs are not treated as corporations for purposes of Section 1061. While uncertainty remains with respect to how these rules will interact with PFIC reporting on a net basis, it is now clear that PFICs, and QEF elections, cannot be used to avoid Section 1061.

The Proposed Regulations also clarify whether the relevant holding period was solely determined by looking at the partnership’s holding period in its assets, or if the individual who holds the API must also meet the holding period requirements. The proposed rules clarify that the partnership’s holding period in its assets is the relevant holding period. This is good news for new joiners who could receive carry allocations within three years of their carry issuance.

While the proposed regulations help demystify some of the implications of Section 1061, there is still a long way to go.

Next steps for Alternative Investment Funds

It is a critical year for US tax policy and keeping abreast with the changes is more important than ever. To this end, it would be beneficial for alternative investment fund managers to have a discussion with their tax advisors and engage in a modelling exercise, to analyse the impact of various provisions including the forthcoming COVID stimulus package (which could impact US portfolio companies)/scenarios including any potentially negative collateral consequences.

For a deeper discussion on how the above topics may affect your business, please get in touch with your PwC contact or the authors below.

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Sustainable Finance Disclosures Regulations for Alternative Investment Fund Managers

As part of the EU's sustainable finance action plan, the European Commission has adopted the Sustainable Finance Disclosure Regulation ("SFDR") which is accompanied by the Taxonomy Regulation. The SFDR comes into effect on 10 March 2021, and its implications for Alternative Investment Fund Managers ("AIFMs") will be the focus of this article.

SFDR requires firms to act in the best interests of end investors through the promotion of transparency around sustainable investments that contribute or negatively impact environmental, social and governance factors. Whilst the Taxonomy Regulation establishes the criteria to determine whether an investment is environmentally sustainable or not.

Scope

SFDR applies to financial market participants ("FMPs"), which include AIFMs and investment firms that provide portfolio management, and financial advisers ("FAs"), which include firms that have been appointed by an AIFM to provide investment advice with respect to an alternative investment fund ("AIF"). The financial products in scope of SFDR include AIFs.

Transparency and Reporting

SFDR's principal requirement is to further transparency regarding sustainability, including but not limited to, transparency on the integration of sustainability risks; transparency on adverse sustainability impacts at financial product level; and transparency on sustainable investments in pre-contractual disclosures. Firms will have to include certain disclosures on their website as well as periodically report on sustainability risk and factors.

The European Supervisory Authorities ("ESAs") have been working to develop Regulatory Technical Standards ("RTS") for certain requirements of SFDR, which they are expecting to submit to the European Commission by 30 December 2020. One of the objectives of the RTS will be to ensure that firms make disclosures that are clear, simple and not misleading. The ESAs published a consultation on three illustrative mock-ups of the pre-contractual disclosures and periodic reporting in an attempt to harmonise and standardise disclosures. The goal of the RTS is that disclosures provided to investors enables them to make comparisons between financial products and services.

We have summarised the disclosure requirements for both FMPs and FAs below. These requirements will need to be read together with the RTS when they are available.

What disclosures will you have to make?

Financial Market Participants

Pre-contractual disclosures (Offering Document/Prospectus)

FMPs must outline in pre-contractual disclosures (i.e. the AIF offering document) how they consider sustainability risks as part of their investment decision making process and set out the "likely impacts of sustainability risks on the returns of the financial products they make available". If firms consider sustainability risks not to be relevant, they need to provide clear reasons why.

In addition to the above pre-contractual disclosures, the following disclosures must be made in respect of certain financial products.

FMPs with financial products that promote environmental or social characteristics (or both) need to disclose how such characteristics are met and if there is use of a reference benchmark, how this is in line with these characteristics.

FMPs that use indices for financial products with sustainability as part of their objectives must also disclose how the relevant index is aligned with the sustainability objective and provide an explanation how that index differs from a broad market index.

FMPs with financial products that have sustainability as an objective, but do not use indices to measure this, must explain how that objective is achieved.

FMPs with financial products that have reduction in carbon emissions as their objectives, should also "include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement".

(Articles 6, 8 and 9 of the SFDR)

Website

FMPs must publish "information about their policies on the integration of sustainability risks in their investment decision-making process".

(Article 3 of SFDR)

FMPs must include "where they consider principal adverse impacts of investment decisions on sustainability factors" or explain and provide clear reasons in situations where they do not.

(Article 4 of SFDR)

Sustainable Finance Disclosures Regulations for AIFMs cont'd

FMPs that have more than 500 employees (also includes FMPs which are parent undertakings of a large group (as defined in Directive 2013/34/EU with an excess of an average of 500 employees, on a group consolidated basis, during the financial year))are not afforded the option to explain why they do not consider principal adverse impact. Rather, they must include a statement on their "due diligence policies with respect to the principal adverse impacts of investment decisions on sustainability factors". Note, this requirement will be in effect from 30 June 2021.

(Article 4 of SFDR)

FMPs must also include on their websites disclosures how their remuneration policies are consistent with the integration of sustainability risks.

(Article 5 of SFDR)

Similarly, FMPs with financial products that promote environmental or social characteristics (or both), have sustainable investment as an objective, or have reduction in carbon emissions as an objective, must publish certain information onto their websites, including a description of the objective and information on the methodologies used to measure and assess such objectives.

(Articles 8, 9 and 10 of SFDR.)

Periodic Reports

FMPs will need to include information relating to sustainability into their periodic reports. In particular, AIFMs will need to include specified information into the annual reports of the AIFs that they manage. Investment firms that provide portfolio management services will also need to include specified information in reports to clients.

(Article 11 of SFDR)

Financial Advisers

Pre-contractual disclosures

FAs must describe how they have integrated sustainability risks into their investment advice and set out the "likely impacts of sustainability risks on the returns of the financial products they advise on". If an FA considers sustainability risks not to be relevant, it must provide clear reasons why.

(Article 6 of SFDR)

Website

FAs must include "information about their policies on the integration of sustainability risks in their investment advice".

(Article 3 of SFDR)

FAs must include on their website whether they consider principal adverse impacts on sustainability factors on the financial products they advise on or make a statement why they do not make such considerations.

(Article 4 of SFDR)

Sustainable Finance Disclosures Regulations for AIFMs cont'd

FAs must also disclose on their website how their remuneration policies are consistent with the integration of sustainability risks.

(Article 5 of SFDR)

Brexit impact:

At the time of writing this article, the UK government has expressed their intention to stay committed to promoting globally consistent standards for sustainability. However, the FCA have suggested that the EU SFDR rules will not be adopted in their current form in the UK and a different set of UK rules may be on the radar. UK asset managers that market AIFs into the EU will nevertheless have to comply with the EU SFDR requirements and therefore should continue with their efforts to become SFDR compliant with a view to align with potential UK rules that they may be subject to in the future.

Next steps for Alternative Investment Funds

- Consider your firm's current approach to sustainability against the SFDR requirements.
- Review existing sustainability disclosure as well as due diligence policies and remuneration policies.
- Prepare or revise pre-contractual disclosures for applicable offering documents in line with SFDR and the RTS (when available).
- Prepare or revise website disclosures in line with SFDR and the RTS (when available).
- Ensure that marketing materials are in line with the disclosures under SFDR.
- Review any delegated portfolio management agreements or investment advisory agreements to make sure these are line with SFDR.

How PwC can help

Strategy: we can assess the scope and impact of SFDR on your firm and help you develop your firm's internal sustainability strategy and sustainability policies.

Advice: we can advise on the obligations imposed by SFDR and the Taxonomy Regulation on your firm and how these interact with other sustainability-related obligations.

Review: we can review contracts (such as delegated portfolio management agreements and investment advisory contracts) to identify gaps and align them with SFDR.

Disclosure: we can assist in preparation of firm-appropriate website and pre-contractual disclosures mandated by SFDR.

Reporting: we can work with you to develop periodic reports in line with SFDR and appropriate to your business.

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The impact of the Investment Firms Regime and the Investment Firms Prudential Regime on remuneration

In June, the FCA published the first stage of its implementation of the new Investment Firms Prudential Regime (IFPR) which will apply to all MiFID firms and the implementation date is now performance periods after 1 January 2022 in the UK and 26 June 2021 in the EU. The IFPR sets rules for investment firms in a number of areas, including remuneration. The regime is designed such that the rules are proportionate to the size and complexity of firms, however will require many firms to fundamentally re-evaluate how they remunerate their staff. The IFPR is the UK equivalent of the Investment Firms Regime (IFR) which will be implemented across the EU at the same time.

For investment firms, the new regime potentially represents the biggest regulatory change for remuneration since remuneration regulation was first introduced to the financial services sector through the Remuneration Codes. Consequently, firms need to assess how it might impact them and put plans in place to ensure they are compliant by the first performance period for which the rules apply. From a remuneration perspective, the firms likely to be most severely impacted by the new rules are:

- Exempt-CAD firms and firms which are currently not in scope of any of the existing Remuneration Codes, which are brought into scope of remuneration rules for the first time; and
- Firms classified as 'significant', as the new rules will increase the scope of individuals subject to bonus deferrals and payment in non-cash instruments, and will require firms to establish independent Remuneration Committees.

Larger firms will need to think through the technical challenges of delivering variable pay in instruments, deferral of variable pay and implementing formal Remuneration Committees, while all firms will need to consider requirements for their remuneration policy, identification of the individuals in scope of the rules according to prescriptive criteria, disclosure of fixed to variable pay ratios in operation, and the implementation of malus and clawback. The rules will apply to the first full performance period following 26 June 2021 and will apply to employees and partners where applicable.

Application of proportionality

Under the new regime, firms are split into 'significant' and 'non-significant' based on an on and off balance sheet asset test.

The threshold for 'significant' in the UK is likely to be set at €300m, while we are awaiting confirmation of whether various EU territories will choose to increase the threshold beyond the EU default position of €100m. There is currently a lack of clarity over whether this threshold applies on a group or individual basis and therefore firms should consider whether they are significant under both scenarios.

Remuneration requirements for all firms

Identification of individuals in scope

All firms will be required to identify 'Material Risk Takers' (MRTs) or individuals who can create material risks for the firm or the funds it manages, according to prescriptive qualitative and quantitative criteria published by the European Banking Authority. These individuals will be those to whom the majority of the requirements will apply, and typically comprise senior management, control function heads, heads of other key support functions and high earners. High earners are broadly defined as individuals earning over €500k, however there is a process through which firms can apply to their local regulator to exclude high earners from the scope of the rules if they can demonstrate that they cannot in fact create material risks.

Performance assessment

Under the new regime, variable pay for MRTs must consider a combination of financial, non-financial, firm, business unit and individual performance. Control functions must be remunerated based on the performance of their function and not the business units they oversee. Bonus pools must link to profits and pools and individual MRT outcomes must be adjusted for performance against risk appetite and risk events that have occurred. This applies to in-year bonuses as well as unvested deferrals and awards that have been paid with firms required to implement malus and clawback.

Disclosure

Although the extent of the full requirements is still unclear, it is likely that firms will have to increase the amount and granularity of information that they currently publish on remuneration including both qualitative information on how MRTs are paid, and quantitative data on what MRTs are paid broken down by various groups of staff. In particular, firms will have to publish their maximum ratio of fixed to variable pay. This could represent a reputational risk where ratios are particularly high and firms will need to think through how to group their MRTs and justify the level of variable pay certain groups may receive. Carried interest is considered variable remuneration and is in scope whereas co-investment is not.

The impact of the Investment Firms Regime and the Investment Firms Prudential Regime on remuneration

Other requirements

The new regime will also include provisions for having a remuneration policy, restrictions on guaranteed variable pay and severance pay, ensuring pay does not undermine a sound capital base, and discretionary pensions. These are likely to be consistent with the other current remuneration regimes that are already in place across the UK and Europe.

Remuneration requirements for significant firms

Significant firms will have to establish independent gender balanced Remuneration Committees as well as implement a number of structural requirements for their MRTs. MRT variable pay will be subject to 40-60% deferral for at least 3 years and 50% of all variable pay will have to be delivered in instruments which will then be subject to a holding period post vesting.

The new regime allows firms to disapply certain rules, such as deferral and payment in instruments, where individuals meet certain 'de minimis' criteria. The EU regulation specifies these criteria as where variable remuneration is less than €50,000; and is less than 25% of total annual remuneration. The FCA has indicated it may consider increasing this threshold, perhaps in line with the current regime (where total remuneration is less than £500,000 of which no more than 33% is variable). Firms can also disapply these structural requirements for carried interest where their arrangements are agreed with investors and have appropriate clawback provisions.

Next steps for Alternative Investment Funds

A crucial first step for firms is to review their licences and permissions. Investment firms need to establish whether the rules apply to them, particularly where there are a number of regulated entities with different permissions within the group. The regime applies on a consolidated basis so it's important to consider the impact of consolidation and whether the rules will apply to entities within the group who aren't impacted on an individual basis as a consequence. Firms should also look at where they are positioned (on a solo and consolidated basis) compared to the proposed significance threshold and therefore whether they expect to be subject to the more onerous rules.

Secondly, as certain requirements such as deferral only apply to MRTs, firms should review their MRT populations. Firms will need to ensure they have identified the correct population and also understand how their governance processes, committee memberships and Senior Management Function designations impact the number of individuals captured and whether changes can be considered, to streamline the population. Finally, once the population has been defined, the interaction with existing regimes such as AIFMD and UCITS V will need to be considered together with the impact of the changing rules on individuals' cashflow. Where firms will be required to deliver variable pay in instruments, and pay is currently delivered 100% in cash, a suitable instrument will need to be identified and implemented. The deferral and payment in instruments requirements will be particularly challenging for private firms and partnerships where pay is not well suited to deferral and there may not be an existing instrument that can be used to satisfy the requirements. The requirements for an independent remuneration committee may also present a significant deviation from current governance practice in these firms.

IFPR and IFR potentially represents a significant regulatory change for remuneration for many investment firms. Consequently, firms need to assess how it might impact them and put plans in place to ensure they are compliant by the first performance period for which the rules apply. Please get in touch with your PwC contact or the authors below if you wish to understand this in more detail.

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Operational transfer pricing: Beyond transfer pricing policy and strategy, building sustainable transfer pricing implementation

In the current climate, transfer pricing implementation requires more attention than ever to reduce the risk of errors in tax compliance, tax leakage and disputes. This is no longer solely an issue for finance and tax teams but touches a large number of internal and external stakeholders; from the CFO to non-executive Directors and other business departments, tax authorities, statutory auditors and internal auditors. In particular, HMRC's initiatives to tackle profit diversion by large businesses, including their approaches on Profit Diversion Compliance Facility ("PDCF") and Diverted Profits Tax ("DPT"), have made the headlines in newspapers over the past few weeks, further highlighting HMRC's (and other tax authorities') inquisitive take on transfer pricing.

For a heavily regulated sector like alternatives, the challenges from a transfer pricing implementation lens increase given the need for alternative investment fund ("AIF") managers to comply not only with tax requirements (which themselves are getting more onerous) but also regulatory requirements such as the Alternative Investment Fund Managers Directive ("AIFMD"), the Markets in Financial Instruments Directive ("MiFiD") II, as well as the upcoming Investment Firm Prudential Regime ("IFPR").

In response to the increasing external and internal pressure, we are seeing AIF managers focus resources in ensuring their transfer pricing processes/governance, and their transfer pricing implementation framework, provide the necessary transparency, data quality and visibility that enable fact-based decision-making and underpin better transfer pricing risk management.

These issues are also relevant for any underlying portfolio companies of the fund, where deal-readiness across all aspects of tax - including transfer pricing implementation - can have an impact that is a high multiple of the financial cost of any investment required to optimise or remediate transfer pricing implementation issues.

The remainder of this article provides an overview of: (i) the transfer pricing lifecycle and operational transfer pricing triggers; and (iii) how governance and implementation processes can be improved to satisfy the requirements of all the stakeholders involved.

The transfer pricing lifecycle and operational transfer pricing triggers

Transfer pricing implementation is at the core of the transfer pricing lifecycle. Whilst transfer pricing strategy, policy and documentation are critical, experience shows that failures in execution substantially increases transfer pricing risks. Tax authorities around the globe are becoming more focused on accuracy, transparency and quality of the data used in the transfer pricing calculations, as well as the underlying process and governance followed. In the UK, this has come into sharp focus both through HMRC enquiries and through Profit Diversion Compliance Facility cases. Globally, regulators also look at transfer prices in cross-border transactions, with an increasing focus on the robustness of the transfer pricing implementation governance and underlying processes and cash flows.

Experience in the AIF sector shows that inadequacies in the transfer pricing implementation often materialise in a lack of transparency in the cost allocations processes (e.g. in the case of management services recharges from the 'head office' to its subsidiaries) and in difficulties around segmentation and profitability monitoring (e.g. legal entity, line of business or product level).

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The areas where we typically see implementation issues materialising for AIF managers, and some of the common pain points include:

- misalignment between the documented transfer pricing policy and the implementation of these policies as result of systems failing, human error, or a disconnect between responsible departments;
- global profit split models being calculated on a cash basis and the results not being converted to local GAAP for purposes of preparing local financial statements or tax returns;
- complexities and inconsistencies in defining revenue in the context of global profit split models;
- challenges on accuracy of data received from finance in relation to budget and forecast (e.g. when pricing intra-group service transactions or cost recharges);
- difficulties in retrieving historical data for local audits (often because data transparency and visibility are opaque);
- difficulties in reconciling data (especially where cost allocations are run regularly - for example, monthly or quarterly);
- reliance on key individuals running manual processes; and
- large year end transfer pricing adjustments resulting in tax risks, tax overpayments or penalties.

Our experience is that many, if not all of these challenges can be successfully addressed through a combination of improvement and optimisation on the people/governance, processes, technology and control aspects of the transfer pricing lifecycle.

What does optimising your transfer pricing implementation mean

To mitigate the risks inherent in transfer pricing implementation and to satisfy the requirements from the various stakeholders, organisations are building comprehensive end-to-end frameworks supporting the implementation of transfer pricing policies, which in some cases involve wholesale re-work of their transfer pricing systems. For others, there is an opportunity to fine-tune or refine existing approaches. In either case, the principal components focus on:

- Designing and optimising transfer pricing processes and workflows holistically across tax, finance, IT and other business areas to develop a holistic governance framework. The rationalisation and simplification of the transfer pricing execution is the first step in optimising the transfer pricing implementation;

Operational transfer pricing: Beyond transfer pricing policy and strategy, building sustainable transfer pricing implementation cont'd

- Standardising transfer pricing processes, by building business process documentation, with the aim of creating an overall robust control environment;
- Identifying opportunities for automation by implementing transfer pricing engines and analytical tools that enable the automation of data extraction, transfer pricing calculations, intragroup invoicing and so on.

Based on our experience of working with AIF managers we are seeing a number of benefits for those groups engaged in the journey of optimising their internal transfer pricing governance and implementation processes. These benefits include, among others: better management of transfer pricing related risks, increased readiness for tax authority scrutiny, internal cost savings - driven by more efficient internal processes - and enabling data-driven decision making.

Next steps for Alternative Investment Funds

Understanding and managing transfer pricing implementation is not new for most AIF managers, but it is increasing in importance. This is driven by tax authority activity, regulatory scrutiny as well as the broader commercial environment. Together, these are giving many AIF managers the stimulus to think through how transfer pricing implementation can be improved and controlled. To succeed in managing the operational transfer pricing aspects, best practice recommendations are to ensure that:

- operational transfer pricing pain points are identified both within and outside of tax;
- you develop a coherent response to the various operational transfer pricing pain points, combining people/governance, processes, technology and controls; and
- comprehensive end to end frameworks are built by designing, optimising and standardising transfer pricing processes, as well as identifying opportunities for automation - whether that is large-scale or tactical.

AIF managers have been most successful in upping their game on transfer pricing implementation where the business case for change is well articulated, clearly understood and has buy-in from senior stakeholders. That typically means tax and wider finance teams being prepared to map out their current processes around transfer pricing execution and understand the pain points and risks as well as the quick wins that operational transfer pricing will bring to the organisation.

The road to operational transfer pricing improvement may not always be straightforward, but with a clear understanding of where you are starting from, a vision of where you are heading, and a decent map of the organisational environment, the journey for all stakeholders - internal or external - will be smoother, thereby improving the ability to meet everyone's expectations along the way.

For a discussion on how to tackle operational transfer pricing in your organisation, please get in touch with the authors of this article or your normal PwC contact.

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Virtual workforce and permanent establishment risks for alternative investment funds

Overview

As discussed in our September publication, 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.

As forms of lockdown across Europe are reinstated and working from home continues over Winter, the case for a heavily office based model for the future continues to be assessed and already, some managers are taking steps to support remote working in the future.

Fund Permanent Establishment Risk

Whilst the risk to the management group of remote working is normally the main focus of questions from clients (particularly where tax transparent entities, such as LLP's, are used in the management group structure meaning potential taxable presence risks of that entity impacts the individual partners as well as to the business itself) it is also important to ensure that the remote working does not lead to unexpected tax risks for the funds.

The general permanent establishment ("PE") rules, whereby a PE is generally created through either (i) a fixed place of business; or (ii) a dependent agent, are no different when considered in the context of a non resident fund entity as compared to any other non resident entity.

Where certain activities are performed in a jurisdiction on behalf of a non-resident fund, it should be considered whether those activities create a PE of the fund.

Typically, it will be necessary for the fund to be "trading" for a risk to exist. There is no fixed global definition of "trading", nor are there domestic definitions in a lot of cases, but more liquid investment strategies are usually at a higher risk of being considered "trading" in nature. It is therefore prudent to assume that open ended liquid funds are trading in nature ahead of conducting a detailed analysis in the relevant jurisdiction at risk.

Double Taxation Treaties

Some funds cannot access double taxation treaties, such as those established in certain zero tax jurisdictions or even those established in high tax jurisdictions but where the entity is either non deemed tax resident in that jurisdiction (e.g. certain partnerships) or where the fund entity relies on a tax exemption, meaning that it isn't subject to tax in that jurisdiction.

The absence of a double taxation treaty to rely on makes assessment harder and thereby increases the risks, as there is no fall back to sometimes stricter domestic legislation nor a standardised approach to assessment which most double taxation treaties seek to ensure.

Even where treaty access may be afforded, the PE article may not provide any further assistance. In any case, further comfort would likely be needed to ensure that the risk position is clear.

Investment Manager Regimes and Exemptions

With this is mind, certain jurisdictions have created specific regimes and exemptions to ensure that the local investment management industry's activities do not create risks for any offshore funds (and/or the investors) managed locally. Unsurprisingly, these jurisdictions are typically those with a large financial services presence such as the US, Hong Kong and Singapore, which all have some form of regime in place and, of course, the UK with the Investment Management Exemption.

Ireland and Australia notably launched their own regimes approximately 6 and 5 years ago respectively and other jurisdictions such as Canada also have a form of safe harbour/regime, albeit these are less clear and tested.

However, all of the above regimes have certain conditions that need to be met, typically restricting activities to certain prescribed and locally regulated investment management services, ensuring the manager is independent of the fund and that the manager is being remunerated for its services and taxed locally. As such, the detailed conditions of each regime need to be considered.

Virtual workforce and permanent establishment risks for alternative investment funds

Other potential protections afforded

Whilst not all countries have specific regimes, many have certain rules or rulings which can be helpful in considering PE risks for the fund.

France and Spain both have rulings where it was stated that a foreign fund should not been treated as having a PE in the jurisdiction where the management of that foreign fund takes place. However, these rulings are based on specific facts and although the precedent is helpful, it should not be assumed that this decision would always apply to each fact pattern.

Some jurisdictions, such as Switzerland, may consider the risk low depending on whether the offshore fund is comparable to certain domestic funds which are not, themselves, taxable in that jurisdiction.

Finally, some jurisdictions do not have the concept of a permanent establishment (e.g. the UAE) or have a zero tax rate (e.g. certain Caribbean islands).

Tax Residence

It is important to note that not all of the regimes mentioned above cover tax residence, although there may be other, separate exemptions which address residency risks. Many countries have a concept of tax residence which focuses on the location of “central management and control” or “mind and management” meaning that offshore entities may be considered to be tax resident in a jurisdiction through the activities of individuals there, even where they are not incorporated in that jurisdiction. As such, the risk here should also be monitored, even where the PE risk may be reduced by an applicable regime or exemption.

A note on regulation

Where a PE risk exists for a fund through the activities performed in a jurisdiction, it is also important to confirm the regulatory position of those activities in that local jurisdiction. Regulatory and PE risks of this nature often go hand in hand, given the nature of the types of activities performed which would give rise to a PE risk for the fund (although this is not always the case).

Further, if relying on an exemption regime, most exemption regimes require the local services performed to be provided by a regulated investment manager, meaning that regulation is often an important condition for exemptions to apply.

Of course, specific regulatory advice should be sought.

Next steps for Alternative Investment Funds

When considering global mobility and remote working tax risks, do not forget to consider any potential impact on the funds. Some jurisdictions have helpful exemptions in place but it should not be assumed that all jurisdictions will have these, nor that all conditions of the exemption rules would be satisfied. Taxation of the fund and the resulting impact on ROI for the investors is a reputational risk not worth taking.

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Cyber Security: A growing threat for Alternative Investment Funds

The UK Government rates the risk of cybersecurity incidents as one of the top threats to critical national infrastructure, alongside more established threats, like the proliferation of weapons of mass destruction and terrorism. PwC's 23rd Annual Global CEO Survey, which involved 1,581 chief executives in 83 territories, highlighted that cyber threats is one of the four top 15 threats that CEOs express increasing concern over including over-regulation, uncertain economic growth, and trade conflicts.

The Financial Conduct Authority (FCA) stated organisations in the Asset Wealth Management (AWM) and wholesale banking sectors have "limited familiarity with the distinct cyber risks their organisations face". In the context of AWM and the Alternative Investment Funds, attackers might be looking to get access not only to personal information, but also trade secrets including trading algorithms and proprietary research. This could result in the loss of investment algorithms and models, or some of the $145 trillion (USD) that PwC estimates the AWM sector will be managing in 2025.

This article provides an overview of the perceived cyber security threats Alternative Investment Funds (including private equity and hedge funds, real estate funds, commodity funds, and others) are exposed to, as well as the role of the financial regulators in this regard.

Which attacks are more likely to hit Asset Wealth Management and Alternative Investment Funds

COVID-19, and the resulting change in working behaviour, has seen an increase in the activity of sophisticated threat actors, due to a wider attack surface. More and more attackers are remaining undiscovered in the target environment, extracting intellectual property, personal identifiable information and financial resources.

In August 2020, the Office of Compliance Inspections and Examinations (OCIE) published a Risk Alert *Select COVID-19 Compliance Risks and Considerations for Broker-Dealers and Investment Advisers* addressing the protection of investors' assets and sensitive information; investment fraud; and business continuity among others.

In this occasion, OCIE emphasised the need to provide training and awareness focused on "(1) phishing and other targeted cyberattacks; (2) sharing information while using certain remote systems (e.g., unsecure web-based video chat); (3) encrypting documents and using password-protected systems; and (4) destroying physical records at remote locations".

PwC threat intelligence, as well as other sources, have highlighted how threat actors are joining forces and orchestrating attacks designed to perpetrate the financial sector. Our latest cyber security report on AWM titled *Under the Lens* has comprehensively detailed the increasing threat in the sector. Next paragraphs will cover some of those threats.
Business email compromise (BEC) or other types of "phishing" attacks are common in private equity and hedge funds, real estate funds and others in the industry. Exploiting human nature, the attacker impersonates a senior executive attempting to coerce the email recipient to share sensitive information, transfer funds or download attachments to spread malware.

Furthermore, AWM and Alternative Investment Funds have also been common targets of Ransomware attacks. Ransomware is a type of malware designed to provide an unauthorised actor access to an organisation's systems while disrupting business operations (e.g. stopping investors from accessing a client portal) until a ransom is paid. The complexity and spread of malware on the network can be significant as seen with Wannacry that impacted the NHS in May 2017.

The OCIE also issued in July 2020 a Risk Alert in regards to Ransomware and how market participants should prepare to address such attacks. Proposed measures include: Incident response, Awareness programs, Vulnerability management, Access management, and Perimeter security among others.

In July, the press rushed to announce a Ransomware attack against a vendor of SEI Investments Co. that developed SEI's investment dashboard. The attack that exposed the personal information of investors in roughly 100 of the fund administrator's clients was detected in May and affected many well known AIF managers and investors.

Cyber Security: A growing threat for Alternative Investment Funds cont'd

The view of the regulators

As mentioned before, the financial regulators have been outspoken about the relevance of cyber security in the industry and the latent systemic risk that can be caused in the financial sector due to a cyber incident. The last few months have seen three recurrent areas in their speeches and national strategies (illustrating the regulator's expectations) and furthermore in the development of regulatory requirements including a) effectively managing cyber risk, b) strengthening operational resilience, and c) overseeing third parties.

Regulators have identified cyber risk as a source of systemic risk to the financial system, which may have the potential for serious negative consequences for the real economy; including severe disruption of critical economic functions, and the undermined confidence in the market. There will be a continued focus on the cyber resilience agenda with the FCA, PRA and the Bank of England working jointly in the implementation of the Operational Resilience Policy.

Next steps for Alternative Investment Funds

Looking at the complexity of the ecosystem, Alternative Investment Funds and other AWM organisations should ensure that their third parties (e.g. investment banks, exchanges, custodians, central depositories, etc.) understand their responsibilities in relation to cyber security, implement adequate security controls, and are ready to demonstrate their security posture.

The FCA has commented on how the whole ecosystem needs to be proactive in improving their cyber security capabilities.

The US Securities and Exchange Commission (SEC) has also looked at regulated investment adviser and broker-dealer firms in the light of cyber security, reminding members to put attention to areas such as endpoint protection, third party management, remote access and risks associated with fund transfer requests and reporting.

Please get in touch with your PwC contact or one of the authors below if you would like to discuss this and how PwC can help in more detail.

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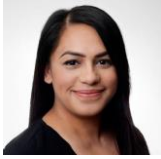

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