Keeping up with Alternative Investment Funds

February 2021

Click to launch

pwc

Introduction

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

With the vaccination rollout continuing to gain speed in the UK and the rest of Europe and oil topping $60 a barrel for the first time in a year, there is increased optimism around the world.

Rapid change and uncertainty still remains in a post Brexit world with technology enabled trading platforms showing just how frictionless trading stocks have become as the world was enthralled by the fortunes of GameStop.

In such times, it is ever important for firms to persist with efforts to remain agile and able to respond to the risks and opportunities this new world presents. As always, we hope you and your families continue to remain safe and well in these uncertain times.

Earlier this month we hosted the first in our series of Brexit and Beyond seminars, we hope you enjoyed it if you were able to join. If you were not able to, you can watch the recording of the session here.

Our next webinar will focus on delivering Substance and will take place on Thursday 18 March at 4pm (GMT). We will consider where the Substance bar has moved to during the Brexit process and where we might see further specific substance requirements from either the FCA or EU regulators as 2021 unwinds. In addition we will look at the people and travel issues as asset managers look to deliver Substance in both their UK and EU operating models.

Please register for the webinar here.

If you have any questions, in relation to the first webinar content or in relation to our next event, then please contact us at: uk_awm_xlos@pwc.com.

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.

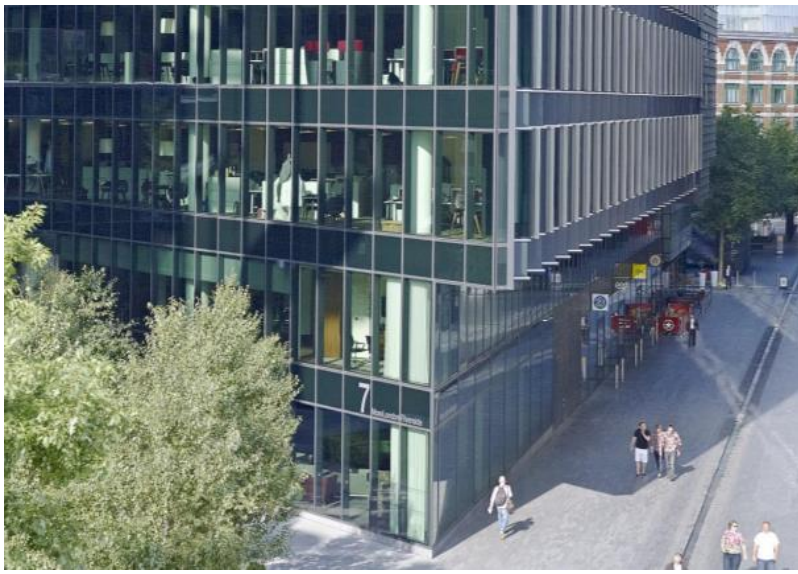
Our February newsletter looks in depth at a number of the varying topics ranging from a review of the AIFMD consultation, a look at Country by Country reporting and an article from our colleagues in Hong Kong giving us an insight into the alternative investment funds landscape. See the full list of articles in this newsletter below:

- AIFMD consultation – analysing the submissions made by key industry groups
- Country by Country reporting
- Luxembourg – Interest Limitation rules
- Navigating through a challenging tax environment: COVID-19, OECD Guidance and key takeaways for AIFs
- Overseas Deep Dive – Hong Kong

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



Marc Susgaard-Vigon
Partner
M: +44 (0) 7795 222478
E: marc.susgaard-vigon@pwc.com

Robert Mellor
Partner
M: +44 (0) 7734 607485
E: robert.mellor@pwc.com

News Bulletin

UK fund regime review

The government has published a call for input in relation to its review of the UK funds regime. The call for input sets out the scope and objectives of the review, which was announced in the 2020 Budget and invites stakeholders to provide views on which reforms should be taken forward and how they should be prioritised.

The call for input, which closes on 20 April 2021, is wide-ranging, covering direct and indirect tax relevant areas of funds regulation and wider reform. The wider reform considers broader issues important to the success of the regime such as the roles of industry and government to make the UK regime successful on an international level thus *"cementing the UK's status as a world-leading hub for portfolio management".*

In particular from a tax perspective, the call for input considers:

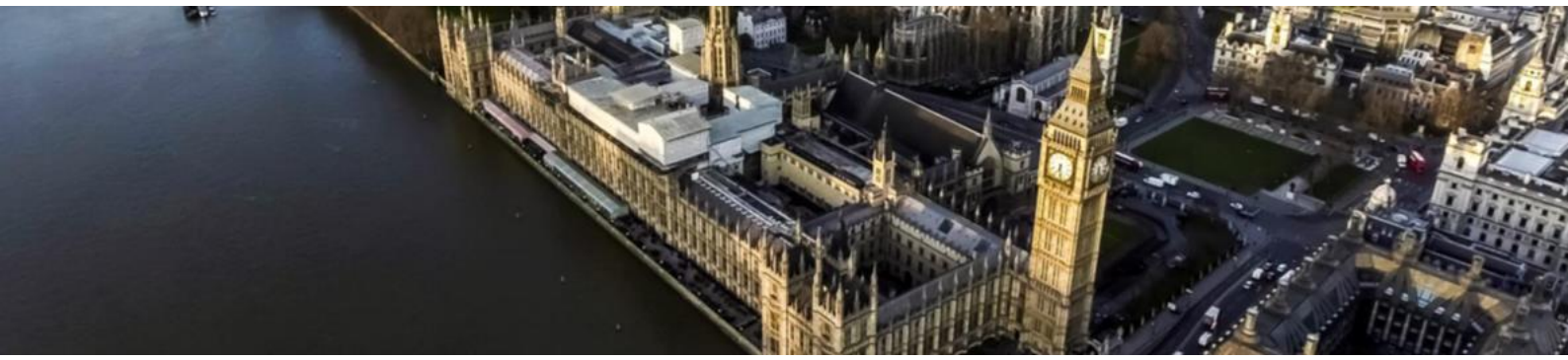
- the principle of tax neutrality;

- barriers and complexity within the current real estate investment trust (REIT) rules; and

- cases where the UK approach to VAT on fund management services can create incentives for the domicile of funds outside of the UK.

The call for input follows a consultation on the tax treatment of asset holding companies in alternative fund structures which last months newsletter set out in detail.

The government has also committed to reviewing the VAT treatment of fund management fees and plans to take this forward in 2021.



Marc Susgaard-Vigon
Partner
M: +44 (0) 7795 222478
E: marc.susgaard-vigon@pwc.com

Robert Mellor
Partner
M: +44 (0) 7734 607485
E: robert.mellor@pwc.com

AIFMD Consultation – analysing the submissions made by key industry groups

Introduction

In this article, we take a look at the recently closed consultation by the European Commission (the "**EC2"**) on the review of the Alternative Investment Fund Managers Directive ("**AIFMD**") (the "**AIFMD Consultation**").

By way of background, the AIFMD required the EC to commence a review of the Directive by July 2017 (the "**AIFMD Review"**) to establish whether its objectives were being met and, if necessary, to propose appropriate amendments. The EC released its report last year (the "**EC Report on AIFMD**") which concluded that while the AIFMD had contributed to the creation of the EU AIF market there were also a number of areas where the legal framework could be improved.

The latest stage of the AIFMD Review which closed on 29th January 2021 sought the views of relevant stakeholders. In this article we have compared submissions from various industry bodies (including the Alternative Investment Management Association ("**AIMA**"), the Investment Association (the "**IA**"), the Association of the Luxembourg Fund Industry ("**ALFI**") and the Irish Funds Industry Association (the "**IFIA**") in relation to some of the keys themes raised by the Consultation. You can find a link to PwC's own network response to the AIFMD Consultation here.

AIFM passport regime

The AIFMD Consultation sought views from stakeholders on the functioning and scope of the AIFM passport.

On this theme, the reaction from the industry bodies that we have reviewed has generally been positive and consistent. AIMA noted that the passport regime has been functioning "reasonably well" and ALFI also noted that the passport is "widely used" and reflective of the approach adopted by many asset managers to set up their AIFM and AIFs in one Member State to prevail of the marketing passport under the AIFMD for the distribution of AIFs across the EU. The IA noted that the barriers to cross-border marketing and investor access are generally due to issues at national level and in local markets, rather than due to the AIFMD framework.

The IFIA argued the case for providing an EU passport for marketing AIFs to retail investors under the AIFMD. The desire for a more retail focussed passport was not shared by all of the industry body submissions that we reviewed. However, ALFI felt that retail clients with sufficient experience should be able to opt-up to professional client status under MiFID.

Depositary Passport

The EC Report on AIFMD noted the lack of a depositary passport as being at odds with the EU's single market approach. However, the industry bodies that we reviewed were not persuaded that the introduction of such a passport was necessary at this time. The IA noted that the lack of a depositary passport has not in any way inhibited the efficient functioning of the EU AIF market and noted that the number of active depositaries in the UK actually increased significantly following the implementation of AIFMD. ALFI also feared that this kind of depositary passport would add new risks of overlapping existing rules to be complied with by industry players which are already subject to a high level of regulatory scrutiny. It also stated that the fact that depositories are currently obliged to operate within the same jurisdiction of the fund greatly facilitates common understanding of standards and requirements.

National Private Placement Regimes

National Private Placement Regimes ("**NPPRs**") allow AIFMs to market AIFs that are not allowed to be marketed under the AIFM passporting regime (such as third country (i.e., non-EU) AIFMs). The AIFMD Consultation sought views on how best to achieve the equitable treatment of non-EU AIFs and securing a wider choice of AIFs for investors while at the same time ensuring that EU AIFMs are not exposed to unfair competition or are otherwise disadvantaged. ALFI noted that NPPRs do not actually create an unlevel playing field at present, but conceded that they have the

AIFMD Consultation – analysing the submissions made by key industry groups

potential in doing so upon the third country passport coming into play with only non-EU AIFs/non-EU AIFMs having access to NPPRs. In AIMA's view, NPPRs do not grant access to the EU single market but only to national/local investors, so the situation of EU AIFMs able to passport and market their funds in all of the EU is not comparable with non-EU AIFMs being allowed by a local NCA to distribute only to that Member State's local investors. The IA also stated that in practice the ability for third country AIFMs to distribute their AIFs in the EU under the NPPRs is very restrictive.

Delegation

The AIFMD Consultation asked whether AIFMD rules on delegation are clear enough to "prevent the creation of letter-box entities in the EU", are consistently enforced across the EU and ensure effective risk management. All of the industry bodies that we reviewed were very positive about the benefits of delegation. ALFI noted that delegation was integral to the EU's open global model and allowed fund managers to offer a wider range of strategies and asset classes, and to reduce costs and find economies of scale. There was also consistency about the current rules on delegation. The IFIA felt that the delegation rules combined with the authorisation and supervisory practices implemented in Ireland have been effective in ensuring that AIFMs can be effectively supervised and in preventing the creation of letter-box entities. Similarly the IA felt that the current rules provided national authorities with sufficient clarity to prevent the creation of letter-box entities in the EU, with no evidence of either market failure or increased risk to financial stability which would warrant changes to the current rules.

The role of ESMA

The AIFMD Consultation posed the question of a more centralised supervision, including entrusting the European Securities and Markets Authority (ESMA) with the authorisation and supervision of all AIFMs and/or non-EU AIFMs and AIFs. The industry body submissions that we reviewed appeared unconvinced by this prospect. ALFI stated that there was no need to change the competences and powers of ESMA. AIMA suggested that Annex IV reports should be submitted to ESMA as the single central authority on a single uniform set of clearly established instructions to avoid ambiguity and to ensure full harmonisation and data quality. However, there should be no change to NCAs' supervisory rights and obligations. Finally the IFIA stated that ESMA and NCAs should focus attention on achieving greater consistency in authorisation and supervisory practices.

Next steps for alternative investment funds

It is noteworthy that on some of the key themes raised by the AIFMD Consultation, the major industry bodies featured in this article have spoken with a consistent voice. However, it is still uncertain whether the EC will be as willing to maintain the status quo. The European Commission response to the AIFMD Consultation can be expected later this year. In the meantime there is plenty for alternative investment fund managers to focus their time on including the Cross-border Distribution of Funds Regulation, (due to come into effect in August this year) and the Regulation on sustainability-related disclosures in the financial services sector (which will come into effect from 10 March 2021). Another key theme is "Substance" and the subject of PwC's next webinar in its "Brexit and Beyond" series on 18 March. As well as exploring where the substance bar moved to during the Brexit process we will consider where we might see further specific substance requirements from either the FCA or EU regulators as 2021 unwinds (including as a result of the EC's review of AIFMD).

Robert Mellor
Partner
M: +44 (0) 7734 607485
E:robert.mellor@pwc.com

David Selden
Partner
M: +44 (0) 7585 311816
E:david.selden@pwc.com

Nick Tye
Manager
M: +44 (0) 7483 399351 E:nick.tye@pwc.com

Country by Country reporting: tax authority practices and lessons from four years of reporting in the investment management industry

In brief

OECD country by country reporting ("**CbCR**") mandates groups of multinational enterprises ("**MNEs**") that have consolidated revenue of more than €750 million or USD 850 to prepare and file a CbC report annually in the jurisdiction of their ultimate parent entity. Relevant rules have been in place for more than four years now and have been transposed into domestic legislation in most countries.

In this article we look at what has changed since the rules were introduced, the current areas of focus for tax authorities and what alternative investment fund managers should be doing to ensure that they remain compliant with the rules.

In detail

Background

Since the OECD published their final version of the BEPS Action 13 paper which contains the original CbCR guidance, a significant number of OECD countries (90 countries) have now implemented CbCR. The OECD has since published regular updates and enhanced technical interpretations to assist MNEs when preparing a CbC report.

Tax authority activity

Over the last few years, we have seen tax authorities reach out to taxpayers to point out technical errors/mistakes in their CbCR report and at the same time requiring them to submit an amended version. For example, HMRC has sent letters to taxpayers asking them to re-submit their CbC report when technical interpretations were not followed or the reports contained formalistic errors. Some of the common errors include: (1) including dividends from Constituent Entities ("**CE**") in revenue and/or profit (loss) before tax on table 1; (2) reporting multiple currencies on table 1; and (3) reporting multiple lines per tax jurisdiction.

Furthermore, CbCR has become an important risk assessment tool for tax authorities in order to verify that tax paid in specific jurisdictions aligns with economic activities and value creation in those jurisdictions. The OECD published a handbook on Effective Tax Risk Assessment to provide guidance to tax authorities in their risk assessment processes. The handbook provides a list of key indicators with the ultimate purpose of helping tax authorities to identify profit shifting into low tax jurisdictions.

In the UK, CbCR data has been used to assist HMRC in performing risk assessments. Noting that tax authorities use the CbCR data in this way, it is therefore important that the CbC report accurately reflects the value chain of the business, which should also be described in the transfer pricing documentation ("**TPD**"). For example, if an investment management firm's CbC report indicates that most of their profits arise in the US, we would expect their business operations, as well as the TPD, to align with this.

Specific issues faced by alternative investment fund managers

We see our clients in the alternative investment funds industry facing two major challenges with their CbCR obligations: (1) technical interpretations for management company structures; and (2) giving sufficient consideration to fund structures when assessing the application of CbCR via the deemed listing rules.

CbCR was not designed to target financial services groups, which leads to various issues around technical interpretations. Table 1 includes three columns containing information on an MNE's aggregated revenues in a jurisdiction: Unrelated Party Revenues, Related Party Revenues and Total Revenues. Some additional issues for alternative investment fund management firms relate to the treatment of revenues from constituent entities vs related parties, understanding whether carried interest should be included in the CbCR or not, and transparent vs opaque entities. There are also differences in treatment between OECD CbCR rules and US CbCR rules for those groups with particular US entities in their structures.

Country by Country reporting: tax authority practices and lessons from four years of reporting in the investment management industry

As noted, another common issue for our clients is identifying their filing obligations outside of the management company structure. OECD guidance states that investment funds are not exempt from CbCR. There are specific rules that require taxpayers to test where an MNE group exists which does not consolidate for accounting purposes, but would be required to consolidate were the top entity to be listed on a stock exchange in the jurisdiction of its tax residence (the "deemed listing provisions"). Based on our experience, alternative investment fund managers tend to spend less time reviewing their hypothetical consolidation points, particularly at the fund level. The deemed listing provision does not require taxpayers to actually prepare consolidated financial statements for CbCR purposes. Instead, MNE groups can derive the consolidated group revenue using available standalone financial statements for purposes of assessing whether the revenue threshold is met. An example could be a fund holding several investments or portfolio companies in different jurisdictions, where the global revenues of the fund and fund holdings exceeds the EUR 750 million revenue threshold. If the fund does not consolidate its investments, it could still be in scope of CbCR if the fund, as the top holding company, would have to consolidate its investments if it was traded on a public stock exchange.

Next steps for alternative investment funds

CbCR rules have been in place for several years and during that period, the OECD has frequently published updated guidance, including specific guidance around consolidation and the deemed listing provisions (which have caused issues for both fund managers and their funds over the years). For this reason, taxpayers need to ensure they are staying on top of any additional guidance released, as well as understanding the potential impact on their CbCR filings. This is particularly relevant as HMRC is actively reaching out to companies asking for a resubmission when CbC reports have not been filed in line with the OECD guidance. Furthermore, as we know HMRC and other tax authorities utilise CbCR data in their risk assessment process, therefore, ensuring this represents an accurate picture of your business is critical.

Amanda Pybus
Director
M: +44 (0) 7787 863825
E:amanda.m.pybus@pwc.com

Rochelle Gianfrancesco
Director
M: +44 (0) 7701 296047
E:rochelle.m.gianfrancesco@pwc.com

Frederic Lorenz
Senior Manager
M: +44 (0) 7718 979100
E:lorenz.frederic@pwc.com

Krisli Klaarman
Senior Associate
M: +44 (0) 7483 389610
E:krisli.k.klaarman@pwc.com

Luxembourg – Interest Limitation rules

On the 8th January 2021, the Luxembourg tax authorities issued the long-awaited Circular on the application of the interest limitation rules in Luxembourg.

To recap, the Luxembourg interest limitation provisions have been in force since 1 January 2019 and apply to potentially restrict the tax deduction in respect of "exceeding" borrowing costs. Exceeding borrowing costs are defined as the tax deductible borrowing costs that are in excess of the taxable "interest revenues and other economically equivalent taxable income" (referred to as "**interest revenue**" for the remainder of this article) of the taxpayer.

Broadly the rules operate so that exceeding borrowing costs are only deductible up to the higher of: i) 30 % of EBITDA, or ii) EUR 3 million.

The Circular sets out the Luxembourg tax authorities' interpretation and intended practical application of the rules and provides some helpful clarity in the following areas:

Definition of borrowing costs

The Luxembourg Law provides a clear definition of borrowing costs costs as being interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance. Further the law sets out a non-exhaustive list of items which fall within the definition.

While it stops short of providing an exhaustive definition of what constitutes borrowing costs, the Circular does provide some additional guidance on the concept as well as some commentary on the examples provided in the law.

Interpretation of what constitutes interest revenue

General

Unlike with borrowing costs, the Luxembourg law does not provide a definition of what constitutes interest revenue, nor does it provide guidance on how the concept should be interpreted. While there is a reasonably clear definition of borrowing costs, to date, the same has not been true in respect of interest revenue.

This has presented something of a challenge to taxpayers and practitioners in applying the law (as understanding the level of interest revenue in a company is needed in order to determine whether and to what extent the company has exceeding borrowing costs). In this regard the new Circular is helpful as it confirms that a "symmetrical" approach should be followed in interpreting what constitutes interest revenue. Very broadly, this means that if an item of income received by a creditor would be considered a borrowing cost on the debtor side then it should be considered as interest revenue (and vice-versa).

Accordingly, this should give more clarity to taxpayers and practitioners in applying the rules as the symmetrical approach proposed by the circular should allow for the more extensive guidance on what constitutes borrowing costs to be consulted in interpreting whether or not a return item is interest revenue.

Implications for returns on non-performing loans ("NPLs") acquired at a discount

The issue of whether gains made on NPLs acquired at a discount constitutes interest revenue is something that many Luxembourg companies, and in particular Credit Fund platforms, have had to contend with since the introduction of the rules.

Luxembourg – Interest Limitation rules continued.

On this matter, the Circular clarifies that expenses which are booked as a result of the impairment of non-performing debt should not be regarded as borrowings costs. Taking this into account alongside the symmetry principle discussed above, there may now be a position that gains made on non-performing loans should not be considered to be interest income.

Clearly this is a matter that will need to be assessed based on the specific facts and circumstances, however companies holding NPLs that are keen to avoid modifications to their financing structure may consider this to be a position worth exploring.

Grandfathering

When determining the amount of exceeding borrowing costs, taxpayers are able to exclude exceeding borrowing costs arising from debt issued before 17 June 2016. However, the exclusion does not apply in instances where debt instruments issued before 17 June 2016 are subsequently modified.

The Circular provides some guidance on what should be considered a subsequent modification and gives a series of examples of changes that should be viewed as modifications and those which should not. Amongst the examples, the following two are notable:

- additional draw-downs on an existing facility, within the limits of the terms and conditions of the facility as applicable before 17 June 2016, are not to be seen as a subsequent modification of the debt. As such, borrowing costs relating to these additional draw-downs are therefore not subject to the interest limitation rules; and
- a change of one or more of the parties to the loan, post 17 June 2016, is to be seen as a modification, but only in cases where the change was not contractually foreseen before 17 June 2016. However, importantly, where a change to one of the parties to a loan is as a result of a restructuring (such as a merger or division), provided there are no changes to the initial conditions of the loan, this should not prevent grandfathering from continuing to apply.

Other

Interaction with other restrictions on expense deductibility

The Circular further confirms that the limitation on deduction only concerns items which remain deductible after the application of other rules, including notably the anti-hybrid rules and the participation exemption "recapture" rules.

Determining EBITDA

The guidance reiterates that exempt income, and expenses connected to such exempt income, are not to be taken into account in the computation of EBITDA.

Carry forward of exceeding borrowing costs

The Circular also provides some guidance on rules linked to the carry forward of exceeding borrowing costs, or of unused interest capacity, and to the specific exemption applicable to long-term infrastructure projects.

Next steps for alternative investment funds

There is clearly a lot of useful clarity provided by the Circular and there is no doubt that it addresses some of the difficult questions that taxpayers have contended with since the introduction of the interest limitation rules.

In the light of this further guidance, taxpayers should review the Circular and continue to assess their situation considering the potential impact of the interest limitation rules which are effective for tax years starting 1 January 2019.

Jim Whittle
Director
M: +44 (0) 7841 560469
E:jim.whittle@pwc.com

Luc Petit
Partner - Luxembourg
M: +352 4948 483148 E:luc.petit@pwc.com

Navigating through a challenging tax environment: COVID-19, OECD Guidance and key takeaways for AIFs

The COVID-19 pandemic is requiring alternative investment fund ("**AIF**") managers to deal with unprecedented challenges. This article focuses on the issues arising from two particular areas (i) cross-border working (e.g. as a result of displaced workers) and resultant permanent establishment ("**PE**"), corporate residence and employment tax challenges; and (ii) validity of the transfer pricing ("**TP**") models in light of the pandemic. The OECD has recently released two papers to help taxpayers and tax administrations address some of these unique tax challenges.

The following sections outline the key issues faced by AIF managers around cross-border working and TP models in light of the pandemic; how they have been approaching these to date; and what the latest papers from the OECD on double taxation and TP mean for the industry.

Cross-border working - PE, corporate residence and employment tax considerations

The issue of cross-border working (e.g. as a result of displaced workers and an increasingly virtual workforce since the beginning of the pandemic) has created uncertainty for AIF managers with respect to PE, corporate residence and employment tax risks. In our experience, AIFs have adopted one of three approaches to managing these risks to date:

- When lockdown and travel restrictions in the UK and elsewhere began to lift last summer, some AIF managers requested remote workers to return to their 'normal' working location and restricted (or altogether banned) future cross-border working.
- More typically, AIF managers have established frameworks for monitoring and managing the risks, for example, by implementing formal approval processes and allowing individuals to spend a certain number of days working overseas up to a certain threshold (depending on the jurisdiction and relevant Double Tax Treaty).
- Others have put in place measures to accommodate certain individuals working overseas on a more permanent basis, establishing branches or entities and allocating profit to reflect the activities undertaken.

Against this backdrop, many AIF managers are re-assessing their operating models and thinking about how to accommodate a more virtual workforce in the future (e.g. through more extensive branch structures), particularly in the context of attracting and retaining talent in their risk assessment processes.

Navigating through a challenging tax environment: COVID-19, OECD Guidance and key takeaways for AIFs

The OECD Secretariat guidance on tax treaties and the impact of the COVID-19 pandemic

On 21 January 2021, the OECD Secretariat published updated guidance on tax treaties and the impact of the COVID-19 pandemic ('OECD Secretariat paper'), updating the guidance previously published on 3 April 2020. The guidance published in April 2020 focussed on the 'temporary and exceptional' nature of working arrangements arising as a result of various lockdowns and travel restrictions imposed as a result of the pandemic. The updated OECD Secretariat paper is intended to cover some of the additional fact patterns that were not addressed in detail in April 2020. The paper focuses on some of the practical challenges for businesses and workers as a result of public health measures imposed or recommended by governments, particularly in relation to cross-border working and the implications for taxing rights in different jurisdictions. The paper reflects a Secretariat view on the interpretation of various treaty provisions and is intended to provide a degree of certainty to taxpayers in interpreting treaty provisions in certain circumstances. However, it is noted that each jurisdiction may adopt different interpretations.

Permanent establishment

There is a clear recommendation to local tax authorities to acknowledge that people working from home during the pandemic, or temporarily having to conclude contracts outside of the employing entity's location, should not give rise to a PE, provided that public health measures are/were in place that restrict the ability of the employee to return to the employing entity's location. This is primarily due to the temporary nature of the activity (or lack of habituality in the case of the conclusion of contracts). However, it is recognised that if the individual(s) were located outside of the employing entity's location, or were habitually concluding contracts in that jurisdiction, before such measures commenced, or continue to do so afterwards, an analysis of all the facts or circumstances will be necessary to assess whether the activities have been performed with sufficient degree of permanency or habituality to create a PE.

Residence status

The paper also considers the situation where board members or other senior executives are unable to travel for meetings, thus potentially impacting the 'place of effective management' of a company and consequently its residence. Similar to the stance on PE, the paper states that it is unlikely that the pandemic will result in any changes to the residence status of a company, as the inability to travel and the change in location of certain individuals should be considered an extraordinary and temporary issue. A company's "usual" and "ordinary" place of effective management is what will drive its residence status. A temporary change in circumstances would not be expected to impact this.

Employment tax

The right to tax employment income under most treaties is allocated between an employee's jurisdiction of

Navigating through a challenging tax environment: COVID-19, OECD Guidance and key takeaways for AIFs

residence and the place where they perform their employment ('**host jurisdiction**') according to specific criteria. If an individual begins to exercise their employment in a host jurisdiction, a treaty may allow that jurisdiction to tax the income if the employer is also resident there (or has a PE there that bears the cost), or the employee passes the day count test (usually 183 days). The OECD Secretariat paper suggests that where an individual is unable to travel from the host country, any such days should be discounted when looking at the 183 day test. However, the paper also stresses that an individual who merely follows government recommendations to avoid unnecessary travel may fall outside the rules covering 'public health measures' and hence it may not be possible to discount days of presence in the host country in all cases. It is important to remember that the OECD Secretariat paper is intended as guidance only and, as a consequence, we are aware that some countries are not intending to apply a more relaxed view of the 183 day test in the treaty hence if a company intends to rely on the relaxation, we would recommend ensuring this will be accepted by the host country tax authorities.

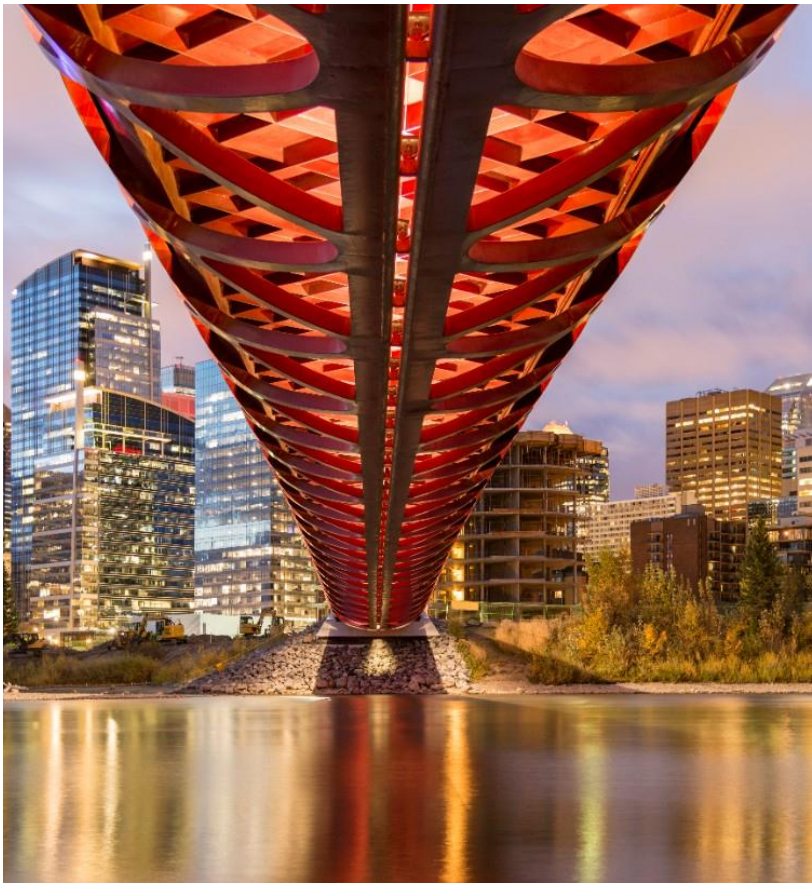
Impact of the COVID-19 pandemic on TP models

On the whole the AIF industry has fared well through the pandemic, unlike most consumer-facing / retail industry players who have faced significant supply chain disruptions, cash flow constraints and business interruption for the past year. The guidance on TP implications of the COVID-19 pandemic (the "**TP Guidance**"), published on 18 December 2020, is primarily aimed at those businesses, and will be most relevant for AIF managers whose performance and profitability has been adversely impacted through the pandemic.

The TP Guidance represents the consensus view of the 137 members of the Inclusive Framework on BEPS and aims to guide and reinforce the applicability of the arm's length standard. It emphasises that the objective of any TP analysis is to 'find a reasonable estimate of an arm's length outcome' and stresses that taxpayers and tax administrations should exercise judgement to achieve that objective in the face of the challenges created by the pandemic. It focuses on four main areas: (i) comparability analysis, (ii) losses and the allocation of COVID-19 specific costs, (iii) government assistance programs; and (iv) advance pricing agreements. A summary of the key messages and applicability to AIF managers is provided below:

Comparability analysis. Given the challenges that arise from relying on comparability analysis based on historical data (which may not reflect the economic conditions of the pandemic), the TP Guidance discusses a number of practical approaches that can be adopted to address information deficiencies (e.g. use of macroeconomic data, adjustments based on taxpayer's information or the use of statistical methods). For AIF managers, comparability analysis is typically most relevant in determining an arm's length price for functions such as back office and investment research support, as well as other benchmarkable functions such as capital raising, and consideration should be given to the financial impact of the pandemic on comparable service providers.

Losses and the allocation of COVID-19 specific costs. The TP Guidance emphasises the importance of the allocation of risks between the parties to an intercompany arrangement, and how profits or losses would be allocated between independent parties under a comparable arrangement. For AIF managers, this could be relevant if the pandemic has created fee pressure from investors, or negatively impacted performance fees. Under such scenarios, AIF managers should consider whether the existing TP policies appropriately allocate losses/eroded revenue streams to the parties assuming the relevant risks.



Navigating through a challenging tax environment: COVID-19, OECD Guidance and key takeaways for AIFs

Government assistance programmes. The TP Guidance also discusses government assistance programmes (e.g. wage subsidies) and whether the economic benefit of such government assistance should be retained by the entity that directly receives it, or passed on to another related party. This is less likely to be relevant for AIF managers who, in our experience, have not needed to rely on government assistance programmes despite the challenging economic environment.

Advance pricing agreements. The TP Guidance recommends a careful analysis to assess the extent to which, if any, the change in economic conditions affects the application of existing APAs or negotiation of existing APAs, encouraging a transparent dialogue between taxpayers and tax authorities. Again, given APAs are not commonplace within the AIF industry, this aspect of the guidance will not be relevant for most.

Next steps for alternative investment funds

Businesses should continue to monitor current operating models and people movements and identify how the guidance detailed in the OECD Secretariat paper could apply. In considering potential PE risk and corporate residence status it will be important to determine whether temporary arrangements were a result of public health measures restricting travel, or whether such arrangements were in place prior to (and / or will continue after) such measures are lifted. Understanding the role of any cross-border workers and their ability to bind the management companies and / or fund(s) will be crucial, with particular sensitivity around those that perform key investment management and/or capital raising activities. Assessing any existing presence in the relevant jurisdiction(s) will also be important, whether this is through a taxable presence or not. In the case of employment taxes, employers and employees should proactively monitor working arrangements in the context of relevant thresholds. Consideration should also be given to other potential risk areas, such as regulatory, VAT and immigration (i.e. whether the individual has the right to work in the host country).

To the extent the pandemic has had a financial impact on the business, any implications for TP models will need to be carefully assessed in light of the recent OECD TP Guidance. Any changes should be underpinned by a commercial rationale and the arm's length principle. For example, any renegotiation of the terms and conditions to existing contracts (e.g. between a lead manager and its sub-advisor) must be in line with what independent parties would agree to under similar conditions. Similarly, any reduction in the mark-ups of cost plus service providers should be supported by a robust comparability analysis.

In all cases, it will be important to gather appropriate evidence and documentation to substantiate the positions adopted on the above issues (including notices of travel restrictions and public health measures, records of any discussions or other communication relating to pricing and contract negotiations), in order to ensure businesses are adequately prepared for potential tax authority scrutiny.

Amanda Pybus
Director
M: +44 (0) 7787 863825
E:amanda.m.pybus@pwc.com

Rochelle Gianfrancesco
Director
M: +44 (0) 7701 296047
E:rochelle.m.gianfrancesco@pwc.com

Nicholas Carling
Director
M: +44 (0) 7894 461620
E:nicholas.carling@pwc.com

Thomas McLarty
Senior Manager
M: +44 (0) 7701 295673
E:thomas.a.mclarty@pwc.com

Carlos Garcia Cuesta
Manager
M: +44 (0) 7483 421583
E:carlos.g.cuesta@pwc.com

Overseas Deep Dive – Hong Kong

Overview of the Hong Kong asset and wealth management industry

As a leading fund management centre with a large concentration of international fund managers, advisory businesses and private banks Hong Kong (**"HK**") is the largest international asset management hub in Asia. It is also the largest international private wealth management and hedge fund centre in Asia, and the second largest private equity centre after China in Asia.

Based on the recent "Asset and Management Activities Survey 2019 " issued by the Securities and Futures Commission ("**SFC**") in August 2020, HK's asset and wealth management business grew in 2019 with a 20% year-on-year increase in AUM to US$3,694 billion. Net fund inflows of US$ 214 billion were recorded for the asset and wealth management business during 2019 (2018: US$ 100 billion).

From a tax perspective, HK already has safe harbour rules in place to allow fund managers to perform investment management activities in HK without exposing the funds to HK profits tax (provided that the conditions are met). HK managed Investment funds themselves generally rely on the Unified Fund Exemption Regime ("**UTE**") which sets out a set of safe harbours to protect investment funds from suffering HK profits tax, should conditions be met. Further, services provided to a HK managed investment fund by a HK investment manager should not be subject to GST/VAT as HK does not have a GST regime.

The HK government has further released several important policies in 2020 / early 2021 to put HK in a much more competitive position as a regional and international asset and fund management centre.

Regulatory Updates – Limited Partnership Fund (LPF) Bill, effective from 31 August 2020

On 9 July 2020, the HK Legislative Council passed the LPF Bill, allowing funds to be set up as HK registered limited partnerships with effect from 31 August 2020. A HK LPF is akin to an existing limited partnership in the Cayman Islands. The HK LPF Bill introduces a new registration regime for partnership funds to be established and operated in HK. The regime gives market players more flexibility in structuring the fund vehicle and operations, and more importantly in aligning the domicile of the fund with commercial substance under the current international tax and regulatory environment. A HK domiciled fund with substance in HK would set a good foundation for the fund to enjoy tax treaty protection.

Legalities, governance and key features of a HK LPF

A HK LPF is a registration scheme and not a legal person itself. It can be used for private equity, venture capital, real estate, infrastructure, hedge fund, etc.

A HK LPF has at least two partners, i.e. one general partner (GP) and at least one limited partner (LP). The partners have freedom to contract. The LPF regime currently does not cater for inward re-domiciliation of funds. However, the HK government has recently introduced legislative proposals to allow a non-HK limited partnership or corporation to be registered as an LPF or open-ended fund company in HK. It is anticipated that the re-domiciliation bill will be introduced to the Legislative Council in the second quarter of 2021.

The General Partner ("GP")

The GP is either a HK private company; a non-HK company registered with the HK Companies Registry; a natural person; or a limited partnership (HK or foreign). It has unlimited liability and ultimate responsibility for management and control of the LPF. If the GP has no legal personality, an authorised representative must be appointed by the GP to be responsible for the management and control of the LPF.

The Investment Manager ("IM")

The GP must appoint an IM (which can be the GP itself) which is a HK resident or HK incorporated company or a non HK incorporated company that has registered in HK. An IM will carry out the day-to-day investment management functions of the LPF. If the IM carries out regulated activities in HK, it should obtain the requisite license(s) from the HK SFC.

The Limited Partner ("LP")

The LP is either a natural person, a corporation, a partnership, or an unincorporated entity. The LP will not have day-to-day management rights nor control over the underlying assets held by the LPF.

The Responsible Person

The GP must appoint a responsible person (which can be the GP itself) to carry out the obligations under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance ("**Ordinance**"). The responsible person can be a HK authorised institution, an SFC licensed corporation, an accounting professional or a legal professional defined under the Ordinance.

Overseas Deep Dive – Hong Kong

Regulatory Updates – SFC's Consultation Conclusion on the Proposed Enhancements to the Open-ended Fund Companies (OFC) Regime

An OFC is a HK domiciled open-ended investment fund to be structured in a corporate form rather than as a unit trust. On 20 December 2019, the SFC issued a Consultation Paper on their proposed enhancements to the Code on Open-Ended Fund Companies **("OFC Code**"). The proposed enhancements sought to respond to feedback that had been received so as to facilitate the adoption of the OFC structure by the asset and wealth management industry.

On 2 September 2020, the SFC published their conclusion on this topic to confirm their intention to enhance the OFC regime. The key highlights are as follows:

a) The removal of all investment restrictions on private OFCs. A note will be added to the OFC Code to remind OFCs to make clear disclosures to their investors on all material risks specific to the type and nature of assets in which an OFC may invest. Expected to be effective immediately after gazettal amendment of the OFC code.

b) The expansion of entities eligible to act as a custodian of private OFCs to allow intermediaries licensed or registered for RA1 (dealing in securities). New provisions included in the OFC Code to require that investment managers and custodians have sufficient expertise and experience in managing and safekeeping asset classes in which an OFC invests, with corresponding enhancement on risk disclosure in the offering documents, and to keep proper records. Expected to be effective immediately after gazettal amendment of the OFC code with a 6 month transition period for custodians to comply with the new rules.

c) The re-domiciliation mechanism to facilitate the migration of overseas corporate funds to HK. Expected to be effective after the passing of the amendment bill.

In addition, on 23 December 2020, the SFC published their conclusion on another consultation to allow an OFC to appoint a responsible person to perform Anti-Money Laundering ("**AML**") functions. The proposal is intended to align the AML requirements for the different investment vehicles for funds in HK, which includes the new HK LPF that came into effect on 31 August 2020. This is expected to be a 6 month transition period after passing the amendment bill.

Overseas Deep Dive – Hong Kong

Tax Updates – Carried Interest Tax Concession, subject to Legislative Council approval and effective from 1 April 2020 once enacted

On 29 January 2021, the Inland Revenue (Amendment) (Tax Concession for Carried Interest) Bill 2021 was gazetted (the "**Bill**") to introduce a tax concession regime for carried interest. The Bill includes a 0% profits tax rate on eligible carried interest and excludes 100% of eligible carried interest from employment income for the calculation of salaries tax. This is a long-awaited development, and key to the development of the HK asset and wealth management industry.

The Bill will be subject to the scrutiny and approval of the Legislative Council before being enacted into Law. Once it is enacted, the tax concession treatment will apply to eligible carried interest received by or accrued to a qualifying person or a qualifying employee on or after 1 April 2020, for year of assessment 2020/21 and subsequent years of assessment.

Over the past few years, PwC, together with industry players, have lobbied for clarity and certainty on the tax treatment of carried interest. This carried interest tax concession Bill is a big step towards alleviating the industry's concerns on the taxation of carried interest, and ensures HK remains an attractive and competitive location for fund managers. The carried interest tax concession follows the various measures the government has already implemented to bolster HK's position as a leading international asset and wealth management centre, including the UTE for funds, the OFC regime, and the LPF regime. We expect the industry would be eager to see the fruition of a practical carried interest tax concession.

Qualifying carried interest payer

Qualifying carried interest payer is defined to be:

1. A "fund" as defined under the unified tax exemption regime for funds ("**UTE**") of the Inland Revenue Ordinance ("**IRO**") and certified by the HK Monetary Authority ("**HKMA**");

2. An associated corporation, or an associated partnership, of a certified investment fund that is a corporation or a partnership; or

3. A specified entity (defined to mean The Innovation and Technology Venture Fund Corporation ("**ITVFC**") incorporated under the Companies Ordinance).

In the case of a non-resident fund, an authorised local representative must be appointed who will be responsible for providing the necessary particulars and information to the Inland Revenue Department ("**IRD**") and HKMA on behalf of the non-resident fund.

Eligible carried interest

Eligible carried interest is defined to mean a sum received by or accrued to a person by way of profit-related return subject to a hurdle rate. A profit-related return must fulfil all of the following conditions:

1. The eligible carried interest arises only if there are profits for a period on the investments, or on particular investments, made for the purposes of the certified investment fund concerned, or there are profits arising from a disposal of the investment of the fund;

2. The eligible carried interest paid would vary by reference to the profits; and

3. The returns to external investors are also determined by reference to the same profits.

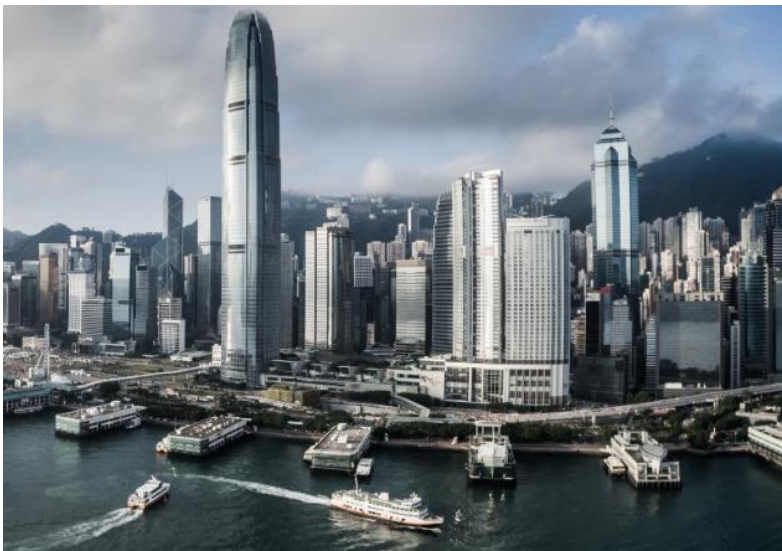
Qualifying carried interest recipients

Qualifying carried interest recipients are defined to mean the following persons providing investment management services to a certified investment fund or a specified entity in HK, or arranging such services to be carried out in HK:

1. A corporation or an authorised financial institution licensed under Securities and Futures Ordinance ("**SFO**") of HK;

2. A person, who does not fall within (1) above, providing investment management services in HK to a certified investment fund or a specified entity, or arranging such services to be carried out in HK; and

3. An individual deriving assessable income from the employment with the qualifying persons referred to in paragraphs (1) and (2) above or their associated corporation or associated partnership by providing investment management services in HK to the certified investment funds or the specified entity on behalf of the qualifying persons.



Overseas Deep Dive – Hong Kong

Qualifying transactions

The concessionary tax treatment would be ring-fenced to eligible carried interest arising from qualifying transactions in private equity only. These are:

1. Shares, stocks, debentures, loan stocks, funds, bonds, or notes of, or issued by, a private company specified under Schedule 16C to the IRO;

2. Shares or comparable interests of a special purpose entity (or SPE) or interposed SPE solely holding and administering one or more investee private companies;

3. Shares, stocks, debentures, loan stocks, funds, bonds, or notes of, or issued by an investee private company held by an SPE or interposed SPE from (2); and

4. Incidental to the carrying out of the qualifying transactions from (1) to (3), subject to a 5% threshold.

The qualifying transactions also have to meet all the relevant tax exemption conditions under the UTE before the eligible carried interest is eligible for the tax concession.

Carried interest from hedging transactions may also be eligible for the tax concession, subject to conditions.

Substantial activities requirements

Qualifying carried interest recipient has to meet the substantial activities requirements for each year of assessment for the period from the date when the qualifying carried interest recipient begins to perform investment management services to the certified investment fund to the date when the carried interest is received or accrued to the qualifying carry recipient:

1. Average of two or more full-time employees in HK who carry out the investment management services; and

2. HK$2 million or more operating expenditure incurred in HK for the provision of investment management services.

HKMA's certification and ongoing monitoring mechanism

Funds need to go through a certification and application process with HKMA before it is eligible for the regime. In the year of carried interest distribution, external auditor needs to verify the satisfaction of relevant substantial activities requirements and the requirements of eligible carried interest. Qualifying carried interest recipients and certified investment funds should provide information to the IRD on distribution of eligible carried interest and keep sufficient records.

Next steps for alternative investment funds

We are pleased to see that HK government has taken an active approach in 2020 to refine its various tax and regulatory policies for the alternative investment fund management industry. With the international tax environment becomes challenging, there is an anticipated trend that more fund managers will opt to localise their investment management businesses in HK and the increasing clarity and availability of regulatory and taxation regimes should be welcomed.

Rex Ho
Partner – Hong Kong AWM Tax Leader
M: +852 2289 3026 E:rex.ho@hk.pwc.com

Eric Gong
Senior Manager – Hong Kong FS Tas
M: +852 2289 5626 E:eric.t.gong@hk.pwc.com

Lachlan Roos
Partner
M: +44 (0) 7738 311271
E:lachlan.j.roos@pwc.com

Peter Witton
Director
M: +44 (0) 7702 699224
E:peter.witton@pwc.com

Contacts

For additional information please contact:

Marc Susgaard-Vigon
Partner
M: +44 (0) 7795 222478
E: marc.susgaard-vigon@pwc.com

Robert Mellor
Partner
M: +44 (0) 7734 607485
E: robert.mellor@pwc.com

Fiona Carpenter
Partner
M: +44 (0) 7818 016620
E: fiona.carpenter@pwc.com

Malcolm Collings
Partner
M: +44 (0) 7702 678205
E: malcolm.j.collings@pwc.com

Darren Docker
Partner
M: +44 (0) 7761 823601
E: darren.m.docker@pwc.com

Leo Humphries
Partner
M: +44 (0) 7802 659271
E: leo.humphries@pwc.com

Christine Cairns
Partner
M: +44 (0) 7974 207708
E: christine.cairns@pwc.com

Richard Williams
Partner
M: +44 (0) 7725 632540
E: richard.x.williams@pwc.com

Jonathan Page
Partner
M: +44 (0) 7876 446492
E: jonathan.page@pwc.com

Lachlan Roos
Partner
M: +44 (0) 7738 311271
E: lachlan.j.roos@pwc.com

Aamer Rafiq
Partner
M: +44 (0) 7771 527309
E: aamer.rafiq@pwc.com

David Selden
Partner
M: +44 (0) 7585 311816
E: david.selden@pwc.com

Editorial team

Alex Hume
Manager
M: +44 (0) 7483 935682
E: alexander.hume@pwc.com

Dan Heineman
Associate
M: +44 (0) 7483 424124
E: daniel.h.heineman@pwc.com

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors. We accept no liability (including for negligence) to anyone else in connection with this document, and it may not be provided to anyone else.

© 2021 PricewaterhouseCoopers LLP. All rights reserved. PwC refers to the UK member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.

200206-154355-ML-OS