Keeping up with Alternative Investment Funds

April 2021

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Introduction

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

With over one year having passed since the start of the UK's first national lockdown this month has been a time for reflection. The past year has taught us all a great deal about the strength and resilience of the alternative investment funds industry. With COVID-19 restrictions being eased this month we hope many have you have been able to take advantage of this and are beginning to see some light at the end of the tunnel.

Earlier this month we hosted another in our Brexit and Beyond seminars. This session focused on the future of regulation between the UK and EU, what would divergence or convergence mean for asset manager. We heard from a client panel on the challenges of implementing their Brexit response and in gearing up for future change. If you were not able to join, you can watch the recording of the session at your convenience. If there is a Beyond Brexit related topic you would like covered at one of these webinars then please contact us and lets us know.

If you have any questions, in relation to the webinar content 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 April newsletter looks in depth at a number of the varying topics ranging from an introduction to continuation funds, to a look at the latest consultation on UK transfer pricing documentation requirements. See the full list of articles in this newsletter below:

- An introduction to Continuation Funds
- HMRC - Personal & Partnership tax enquiries update
- Consultation on UK Transfer Pricing documentation requirements
- Proposed amendments to the Dutch qualification rules for Dutch and foreign entities

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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An introduction to Continuation Funds

What are they?

The secondaries market is one that has grown significantly over the last 20 years, in line with the growth in the alternatives primary market, and is expected to continue to grow over the coming years. This market focuses on the purchase and sale of existing stakes in alternative investments and provides investors a route to liquidity and increased flexibility in managing their investment portfolio. As the secondaries market has evolved over the years, one aspect that has become increasingly popular is the continuation fund.

A continuation fund is a new fund structure set up with the purpose of acquiring one or more portfolio investments from existing funds with a view to such assets continuing to be managed by the same GP/Manager. Continuation funds may adopt a strategy of maintaining existing assets (with potential for follow-ons if appropriate) or look to expand the investment base to acquire new assets over the life of the continuation fund.

Investors in the existing fund(s) will usually be given an option to sell their interests in the underlying assets or rollover into the new continuation fund structure to maintain their holding. Alongside the invitation for rollover, the continuation fund will typically also seek investment from new investors to replace the existing investors that wish to cash out.

Why are they increasing in popularity?

Although the continuation fund model is not new, it has become increasingly popular over the last few years, with a number of contributing factors:

- A closed-ended fund may be nearing the end of its life, but hasn't been able to sell all its assets. Liquidation of the existing fund would result in a forced exit of the remaining portfolio, which may not be the strategic preference if the manager feels there are still meaningful opportunities for the portfolio businesses to grow.
- Market uncertainty due to COVID-19 and Brexit that has resulted in current asset valuation being sub-optimal, where the expectation is that upcoming stability in the market means there is strong potential for future growth.
- Management may desire to free up investor commitments in the existing fund so that they may make commitments to a separate successor fund.
- A continuation fund can provide increased liquidity for management in respect of their carried interest and co-investment interest in the existing funds.
- Establishing a continuation fund may provide the opportunity to establish an optimum mix of assets in order to obtain sufficient capital to invest across the portfolio (e.g. high risk balanced with low risk, underperforming assets with potential for growth alongside currently high performing assets).

In practice, the decision to set up a continuation fund will often be based on multiple drivers, with a primary focus on optimising investor returns.

What are the key tax, legal, regulatory and commercial issues to consider?

From a tax perspective the key point to consider will be whether the continuation fund will offer rollover investors the right to invest on a tax neutral or tax net basis - ensuring rollover investors are in a tax neutral position may require specific pre-sale structuring, and a more complex form of asset transfer from the existing fund to the continuation fund.

In this regard, there is strong market demand for both tax neutral and tax net rollovers albeit deal specific drivers will include the size of the expected portfolio being transferred, the assets which are the subject of the transfer (i.e. whether equity, debt, derivatives, or a combination), and the existing fund's investor base. It will also be important for the manager to understand the level of existing fund investor rollover required in raising the continuation fund, when ascertaining whether a tax neutral position would be preferable to incentivise these existing investors to reinvest.

From a legal perspective, obtaining a tax neutral rollover will often raise its own challenges. As an example, fund documentation may need to be analysed to understand if a disproportionate distribution in specie will be possible to bifurcate the underlying returns i.e. specifically distribute assets to rollover investors and specifically distribute sale proceeds to cashing out investors as opposed to a proportionate split of assets and cash across the whole pool. In addition some fund agreements will not allow for the distribution in specie of illiquid assets and hence consent to make an adjustment to the agreement may be needed from investors.

An introduction to Continuation Funds (cont'd)

another key point from a tax perspective to consider is the new investor market may also be worth bearing in mind. For example, large players in the secondaries market may request exclusivity in the continuation fund or a maximum continuation fund size, either of which could limit admission of new investors.

The asset package to be held by the continuation fund could also impact the attractiveness to new and existing investors, with some houses offering specific incentives such as the sale of a 'strip' of a high performing asset alongside the main continuation fund asset pool. For completeness, we would not expect a strip sale in this way to be tax neutral on the basis this will be a straightforward sale by an existing fund to the new investors in the continuation fund.

On the transfer of assets into the continuation fund, consideration should also be given to the implications of changes in ownership (legal or beneficial) which could trigger taxes at the portfolio level such as Stamp Duty, real estate transfer taxes and non resident capital gains tax ("**NRCGT**"); and the transfer to the continuation fund could also adversely affect tax attributes within the transferred portfolio companies e.g. operating tax losses which become unusable due to the change in ownership.

A key legal aspect of the continuation fund will be managing conflicts of interest e.g. between selling investors and rolling investors. Limited Partner Advisory Committee involvement may be mandatory prior to implementing a continuation fund strategy and in any case may be helpful in order to provide protection to the GP in this regard. Depending on the assets chosen for transfer, a review of the contractual obligations at the level of the investment may highlight other points to consider such as tag-along rights and coinvestor treatment. Other factors such as regulation at the portfolio company level or additional notification/disclosure considerations may result in a transfer being prohibitive.

Care must also be taken to understand specific restrictions that may be in place such as debt transfer restrictions, management incentive scheme conditions, change of control provisions or exit rights. In particular, specific consent or notification requirements may prevent a transfer from taking place without extensive discussions at portfolio company level.

Financing can sometimes be overlooked but from a practical perspective it is important to establish the routing of cash from sale to reinvestment to ensure appropriate liquidity as these will often be enacted on the same day. Practical points to consider include:

1. *Syndication* - Will new investment in the continuation fund be made as a syndication such that one LP makes 100% commitment on closing followed by a sell-down to other participating LPs post-closing, or alternatively will all LPs make their investment on closing in their final proportionate commitments. Where a syndication style arrangement is not desirable, consideration could be given to utilising a daylight facility agreement or payment direction letters as an alternative to ensure all parties contribute their agreed final commitment proportion on the same day.
2. *Liquidity for rolling investors* - Where rolling investors are not admitted to the continuation fund by way of an asset contribution (i.e. typically in a tax neutral transaction) but rather are reinvesting cash proceeds, this may require a distribution of 'sale proceeds' on asset transfer to enable them to make the re-investment in the continuation fund (or at least thought to be given to netting/payment directions such that cash need not actually flow). This may also link in with the syndication considerations above in terms of timing of expected distribution by reference to closing.
3. *Legal and tax steps* - From a legal and tax perspective, it is important to determine the steps for routing of sales proceeds to ensure they flow up appropriately from the relevant asset holding structures out of the existing funds to investors. For example, if transferring assets are being sold from beneath holding structures which may have been implemented by the existing fund some time ago, it will be necessary to ensure that cash repatriation mechanisms are fit for purpose.

An introduction to Continuation Funds (cont'd)

When structuring the continuation fund, as with any other new fund, it will be important to factor in the tax profile of the investors (whether new, or rollers from the existing fund) when devising the asset holding structure for the transferring investments e.g. taking into account investor jurisdiction treatment of the fund and asset holding structure under the relevant anti-hybrids legislation, or considering the proposed asset holding structure in respect of withholding tax ("**WHT**") and the associated impact on the investors.

In respect of existing carried interest structures that will be impacted by the transfer, it should be highlighted that where a decision has been made that rollover will take place on a tax net basis we would expect reinvestment to be made net of tax on carry arising to the individuals as per the wider investor base. However, care should be taken where a tax neutral rollover is preferred and further thought will likely be needed in respect of structures in carry that will be impacted by the transfer.

Where a tax neutral rollover is pursued, the continuation fund waterfall mechanics will require further thought e.g. new investors may follow one waterfall where the asset valuation is reset as they are contributed to the continuation fund, whereas rollover investors may have a separate waterfall based on the prior fund mechanics or referable specifically to assets contributed in specie by the rolling investors. In some instances, a 'middle ground' may be determined whereby a single waterfall will be applied to the whole investor base of new and rollover investors.

The continuation fund itself may likely be viewed as a new scheme for the purposes of the Income Based Carried Interest ("**IBCI**") rules, and with an average fund life of 4-5 years (as opposed to standard funds of around 10 years) the implications of a weighted average holding period of less than 40 months should be considered.

Next steps for alternative investment funds

The continuation fund is a strategy which has been growing in popularity and can be an attractive option for houses with funds nearing their end of life with assets expected to have significant growth opportunities in the coming years.

We would recommend managers consider their existing funds, assets and valuations alongside investor feedback and communications to determine if a continuation fund strategy may be appealing. Corporate finance advisors may also be able to provide an indication of the current market and help determine whether the expected growth in value of existing assets may exceed the current fund term.

Understanding the investor base for a continuation fund is crucial in determining the viability of the strategy from a commercial and tax perspective, and we would therefore recommend thinking through the level of reliance on existing investors which will also drive the ultimate decision on a tax neutral or net-of-tax rollover.

As a final point for consideration, we would highlight that transfers on a tax neutral basis may often rely on asset holding structures to be maintained from the old fund to the continuation fund - therefore if management has a desire to undertake an asset holding structure reorganisation this may not be feasible as part of a continuation fund setup without triggering some form of taxable event.

The PwC AIF team has extensive experience operating in the continuation fund market and the team members have collectively worked with clients to achieve transfers under all variables noted above. Please get in touch with your PwC team to discuss further, and we will be happy to assist.

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HMRC – Personal & Partnership tax enquiries update

Overview

The introduction of the disguised investment management fees ("**DIMF**") and new carried interest rules in 2015 represented a significant change for the Alternative Investment Fund management industry as HMRC made a significant shift in approach with regards to how investment management professionals are taxed in the UK. These rules came at a time when a number of investment houses were already having to deal with the introduction of the Salaried Member and Mixed Partnership rules, thereby adding to the complexity and uncertainty of the tax landscape in this industry.

Since their introduction, HMRC appear to have intensified their approach towards taxpayers in receipt of DIMF or carried interest, or those who are members of certain partnerships. This has come in the form of coordinated personal or partnership tax enquiries.

Why is this relevant?

- HMRC continue to focus on tax enquiries relating to carried interest, DIMF rules and LLPs.
- HMRC are challenging the technical basis on which returns have been made and are testing the application of complex legislation.
- In many cases, HMRC are gathering information across the industry before committing to their position or concluding enquiries. This means that enquiries can often be drawn out and protracted. The impact of COVID-19 is also delaying the resolution of many historic enquiries.
- We have experience of successfully resolving HMRC disputes across all of these areas and are able to guide you through the full enquiry process working directly with executives, investment management houses and HMRC under a collaborative approach.

Current focus

DIMF and Carried Interest

In the years following the implementation of the carried interest and DIMF legislation, we observed HMRC raising enquiries into the returns of a large number of investment house executives, with an apparent view to better understand how both the individuals and houses had applied the new legislation. Some enquiries involve several executives from the same investment manager, whilst others may only be in relation to one individual.

Over the last 12 months, the current global pandemic has impacted HMRC's ability to raise and progress enquiries.

Whilst enquiries continue to be raised, HMRC's approach has shifted and has become more focused. Historically, these enquiries typically involved a generic and wide ranging information request to better understand the industry and how the legislation had been interpreted and applied. As HMRC have more insight and experience, we are seeing more targeted questions, with enquiries being led by inspectors from a dedicated and more experienced team. This has meant that in some circumstances, simple enquiries have been resolved within one round of correspondence. However, in other cases, HMRC have continued to explore other avenues (having a "second bite of the cherry") despite previously being comfortable with the taxpayers filing.

There appears to be acknowledgement within HMRC that the DIMF and carried interest rules are complex; this is relevant with regards to the imposition of penalties and conclusions on whether DIMF is actually in question. It is also clear that in certain circumstances HMRC believe the legislative provisions apply more broadly than originally thought, with areas of focus including: loans made to certain persons, awards of equity in a listed parent and more recently, the taxation of remittance basis partnerships.

Partnership issues

For partnerships, HMRC continue to focus on the application of the Salaried Member and Mixed Partnership legislation.

Like the DIMF and carried interest enquiries, enquiries in this area are coordinated by a central team. They take a campaign approach, gathering significant amounts of information in order to get better visibility of the industry and the application of the rules.

Effective implementation and associated documentation has been crucial when it comes to navigating through an enquiry. For example when evidencing which of the conditions is failed under the Salaried Member rules, we have seen examples of HMRC asserting that these rules apply if an individual is a few pennies under the relevant capital threshold!

HMRC – Personal & Partnership tax enquiries update

What should you do?

It is clear that how investment management professionals are taxed in the UK is a focus for HMRC and the nature of the enquiries would imply that they are keen to better understand the structures that the industry typically use and the application of the legislation before committing to its position.

This (coupled with COVID-19) means that progress on HMRC's side can be slow and protracted. In these circumstances, we are seeing HMRC raise discovery assessments to give them more time and in an attempt to protect their assessing position where they believe potential historic liabilities have been identified. In certain circumstances, this has resulted in HMRC issuing assessments for years outside of the normal four year assessment time limit on the basis that taxpayers have failed to take reasonable care.

There are a number of things that can help prevent enquiries or result in a simpler resolution process.

For example:

- reviewing your structure & putting in place the correct documentation so that you have contemporaneous evidence on file to support the basis on which partnership and personal tax returns have been filed; and
- Supporting your executives by providing investor reports to help them with reporting carried interest, coinvestment, DIMF and IBCI and ensuring that they include appropriate disclosures.

Taking actions such as these ensures consistency and can remove the necessity for HMRC to request additional information regarding the technical positions that have been taken.

Should HMRC raise an assessment into the partnership or its executives, it is important to check whether they are legally entitled to do so, taking into account the relevant provisions.

On occasions where executives from the same investment house are enquired into on similar terms (whether the individuals use different advisors or not), it is possible to coordinate responses (by appointing the house to act as an agent) to ensure that the most robust and consistent approach is provided to HMRC.

A coordinated approach also prevents duplicate information requests and has allowed HMRC to understand the structure in place at an investment house by engaging with those most familiar with it. It also enables the investment house to have oversight / assist with providing information without HMRC having to exercise their formal information gathering powers.

This way of working reduces down the administrative burden that is often associated with an enquiry and manages the level of communication required between the house and its executives and the time multiple parties would otherwise have to spend in reaching a resolution.

Next steps for alternative investment funds

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Consultation on UK Transfer Pricing documentation requirements

In brief

On 23 March 2021, HMRC released a public consultation document setting out proposed changes to the UK's transfer pricing ("**TP**") documentation requirements. Two main changes are being considered:

The introduction of mandatory Master File and Local File requirements (in line with the BEPS Action 13 Report) for UK multinational enterprises ('MNEs') within the scope of Country by Country reporting ("**CbCR**") requirements; and

The introduction of additional disclosures about cross border transactions with associated enterprises to be included in an International Dealings Schedule ("**IDS**") as part of the annual tax return, for all businesses within the scope of UK TP rules.

These proposals could substantially increase the TP compliance obligations for many UK taxpayers, and HMRC has invited contributions from businesses, advisers and representative bodies on "possible options and design ideas which could benefit UK business and HMRC". The consultation period is relatively short, running for 10 weeks with a deadline of 1 June 2021.

The proposals are consistent with the greater focus we are seeing HMRC place on primary evidence, behaviours and governance demonstrated in the preparation of TP documentation. The potential addition of the "evidence log" and IDS could take the UK to the more complex end of the global compliance spectrum for TP documentation.

In detail

Objectives of the proposals

TP continues to be a major source of tax uncertainty for large UK businesses and a significant area of tax risk for HMRC. The objectives of the changes proposed in the consultation document are to:

- provide greater certainty for UK businesses around documentation requirements for TP;
- provide HMRC with better quality data to enable more efficient and targeted compliance interventions;
- provide a platform for discussions between tax advisers and their clients via readily available TP documentation during the preparation of tax returns; and;
- align the UK's practice more closely with the documentation requirements of other jurisdictions and with the BEPS Action 13 Report, making cross border cooperation more efficient.

Introduction of master file and local file requirements

Whilst HMRC's current guidance references the BEPS Action 13 Report as an example of a standardised approach to TP documentation, and this is generally considered a best practice approach to TP documentation in the UK, there is no formal requirement to prepare TP documentation in this format at present.

The consultation document considers the introduction of a mandatory requirement for UK MNEs within a CbCR reporting group (i.e. a group with consolidated group revenues over EUR 750m) to prepare a Group Master File and UK Local File, which would need to be provided to HMRC within 30 days after a request.

The consultation also discusses potential additional requirements, such as an 'evidence log' which could be included as an appendix to the local file to support the key facts on which the TP policies are based. Reference is made to the Profit Diversion Compliance Facility ("**PDCF**") guidance which includes an example evidence log.

The consultation document sets out a number of questions which are focussed on understanding the extent to which the new requirements will increase the compliance burden on taxpayers, or whether the taxpayers within the scope of the new rules are likely to already be preparing documentation in line with the BEPS Action 13 guidance. There are also questions around potential transactional materiality thresholds, and the appropriateness of the proposed 30 day timescale for the production of the TP documentation.

International Dealings Schedule

The introduction of an IDS would be used to report transactional data about intragroup cross border transactions to HMRC in a structured format which could be used for HMRC's risk assessment purposes, enabling them to run analytics and more efficiently identify industry 'outliers' or significant transaction volumes with 'low tax' jurisdictions.

Consultation on UK Transfer Pricing documentation requirements (cont'd)

All UK businesses within the scope of UK TP legislation would be required to file an IDS under the current proposal, with potential materiality limits being considered to exclude certain transactions and reduce the potential administrative burden.

The consultation document includes the following types of information that could be within the scope of reporting via an IDS:

- The nature and amount of specific types of transactions;
- Details of financial dealings;
- Compensation, receipts or payments of a non-financial nature;
- Information on restructuring activity;
- Information on the TP methodologies applied;
- Information on the level and type of supporting documentation for the TP methodology selected and applied;
- Counterparty details for transactions including identity and country location;
- Information on activities; and
- Corporate group information (to enable entity level data to be combined and attributed to a particular MNE group).

The questions raised in relation to the IDS proposals are aimed at understanding the extent to which organisations' accounting / reporting systems are already able to provide TP data; the extent to which the proposals would impact administrative burdens; types of data and information which could be requested through the IDS; relevant experience of similar reporting requirements for other tax authorities; format and structure of the IDS; and approach to determining transactional materiality limits.

Next steps for alternative investment funds

The number of AIF managers meeting the threshold to produce a Master File and UK Local File under the current proposals is likely to be limited. However, in our experience, most AIF managers are already preparing documentation in line with the BEPS Action 13 requirements, meaning those within the scope of the proposed rules should be well equipped to comply.

Given the proposed introduction of an "evidence log" and the increased focus on evidence we are seeing from HMRC more generally, AIF managers should consider incorporating evidence reviews into their annual TP processes to test and support the key facts on which TP policies are based.

Whilst we expect some AIF managers will be well prepared to comply with the proposed introduction of an IDS, for others this may require significant investment in systems and processes to ensure the information required to submit the IDS can be compiled robustly and efficiently each year.

If you would like further information on the proposals, or if you would like to find out how you can provide input in response to the questions raised in the consultation document, please reach out to one of the contacts listed below, or your regular PwC contact.

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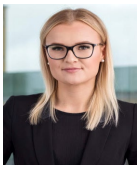

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Proposed amendments to the Dutch qualification rules for Dutch and foreign entities

Introduction

On 29 March 2021, the Dutch Ministry of Finance published a consultation document which includes proposed amendments to the Dutch qualification rules for Dutch and foreign entities. The consultation period ends on 26 April 2021. The aim of the proposal is to reduce the number of hybrid mismatches in an international context. It is envisaged that a legislative proposal will be published after the consultation period and that this proposal will be part of the 2022 Dutch Budget Day tax plan which will be announced on the third Tuesday of September. The amendments are proposed to enter into force on 1 January 2022.

Dutch CVs and comparable foreign limited partnerships

Currently, the qualification of a Dutch limited partnership ('Commanditaire Vennootschap' or 'CV') as either transparent or non-transparent depends on the so-called "consent requirement". Based on this consent requirement a Dutch CV is considered as non-transparent for Dutch tax purposes if the admission or replacement of limited partners is possible without the consent of all other partners.

In practice the consent requirement often results in hybrid mismatches. Therefore, it is proposed that the consent requirement will be revoked. Consequently, a Dutch CV will always be treated as tax transparent. This qualification will equally apply to foreign limited partnerships that are comparable to a Dutch CV.

For Dutch CVs (or comparable foreign limited partnerships) that currently qualify as non-transparent, the change to transparency (by fiction) results in the transfer of assets and liabilities to limited partners. In order to avoid a tax cash-out the consultation document includes various reliefs including conditional roll-over provisions and payment extensions.

FGRs and comparable funds for joint account

In relation to the FGR ('Fonds voor Gemene Rekening') the consent requirement will also be revoked. However, in contrast to a Dutch CV, an FGR could still be either transparent or non-transparent. Under the proposal, an FGR (and comparable funds for joint account) will only be treated as non-transparent if (in short) it meets one of the following two criteria:

- The participation rights in the FGR are publicly traded; or
- The FGR is required upon request to redeem its outstanding participations and this obligation is exercised on a regular basis.

Proposed amendments to the Dutch qualification rules for Dutch and foreign entities

Foreign entities not comparable to a Dutch legal form

Currently foreign entities are classified as either transparent or non-transparent based on their similarities with certain Dutch legal forms. To a certain extent this approach continues to apply. However, foreign entities that are not comparable to an existing Dutch legal form will be qualified based on the following two approaches:

- Fixed approach - if the foreign entity has its place of effective management in the Netherlands, such entity will be considered non-transparent.
- Symmetry approach - if the foreign entity does not have its place of effective management in the Netherlands, the qualification of the jurisdiction where the entity is established is followed.

The consultation document refers a UK Limited Liability Partnership (LLP), an Irish Unlimited Company (ULC) and a German Kommanditgesellschaft auf Aktien (KGaA) as examples of entities that are not comparable to a Dutch legal form.

Next steps for alternative investment funds

We expect that the proposed rules have a positive impact for institutional investors, such as pension funds, investing in (foreign) limited partnerships. Also, the number of hybrid mismatches should reduce quite considerably, and more flexibility is expected for funds pursuing a transparent Dutch CV structure. A number of practical questions do however remain, particularly in respect of the transitional rules (i.e. in relation to reliefs, conditional roll-over provisions and payment extensions)

However, for structures that are already in place, the proposal should be carefully analysed to avoid unexpected results.

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