Keeping up with Alternative Investment Funds

July 2021

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Introduction

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

With lockdown restrictions easing in the UK on the 19th of July but positive cases of COVID-19 increasing there is increased uncertainty about how the easing of restrictions will impact this. Confidence in the markets is still fragile with uncertainty surrounding a third wave of the COVID-19 virus being offset with the continued success of the global vaccine rollout.

Earlier this month (20 July 2021) the Government published draft legislation to be included in the Finance Bill 2021-22 for consultation. Most of the draft legislation follows consultations earlier in the year. We will be covering some of these announcements in future editions of the newsletter.

We recently shared a special edition newsletter that focused solely on ESG ("Environmental, Social, and Corporate Governance"). With ESG becoming an increasingly important issue for alternative investment funds we hope that you found this edition interesting and informative.

We will be taking a break for the month of August and will be returning in September with many interesting topics lined up for discussion in the newsletter.

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 July newsletter looks in depth at a number of topics ranging from a look at the UK's Corporate Criminal Offence rules, EU business tax communication and a Global operational taxes update. See the full list of articles in this newsletter below:

- CJEU's K and DBKAG Judgement
- Why the UK Corporate Criminal Offence rules should still be high on the agenda for Alternative Investment Fund Managers
- EU business tax communication
- Global operational taxes update; and
- Long term asset funds – Worth the wait?

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

Chancellor welcomes milestone G20 progress on global tax reform

Chancellor of the Exchequer Rishi Sunak today (10 July) has welcomed milestone progress on international tax reform during two-day meetings of G20 Finance Ministers and Central Bank Governors in Venice.

- Rishi Sunak welcomes milestone progress on global tax reform at G20 in Venice
- G20 Finance Ministers fully endorse global tax agreement and call for swift action to finalise outstanding detail by October
- G20 also pledged to promote implementation of climate-related financial disclosures

The foundations for the historic agreement on global tax reform were laid at the G7 in London, and now 132 countries and jurisdictions representing 95% of world GDP have signed up to the deal within the OECD.

Following two days of G20 meetings in Venice, including an informal breakfast meeting of the G7 chaired by Mr Sunak, Finance Ministers pledged their full support for the deal and called for outstanding issues to be swiftly addressed at OECD level along with a detailed implementation plan by October. The group also called on countries who have yet to sign up to do so.

The seismic global tax deal will change the international rules so that large multinationals pay their fair share of tax in the countries they do business and introduce a global minimum rate that ensures multinationals pay tax of at least 15% on profit in each country they operate.

HMRC's Legislation Day – Asset Holding Companies draft legislation

On 20 July 2021 the UK Government published its eagerly awaited draft legislation on its new regime for the taxation of qualifying asset holding companies ("QAHCs"). The draft legislation is subject to consultation and is intended to have effect from 1 April 2022 for UK corporation tax, stamp duty and stamp duty reserve tax purposes and from 6 April 2022 for UK income tax and capital gains tax purposes.

The new QAHC regime is intended to address the tax road blocks which prevent the use of a UK company to act as an intermediate holding company to facilitate the flow of capital, income and gains between investors and underlying investments, so that investors are taxed broadly as if they invested in the underlying assets and the intermediate holding companies pay no more tax than is proportionate to the activities they perform.

Not all provisions of the new regime have been published in the current draft legislation and we expect to see a further draft published in the Autumn to specify the rules for entry and exit from the regime and any additional reporting requirements. We also expect to see amendments to other parts of UK tax legislation to ensure existing tax legislation operates as intended with respect to QAHCs and groups involving QAHCs. The timing of the anticipated Government consultation regarding the VAT treatment of fund management fees previously announced also remains unknown.

The draft legislation is the outcome of the two rounds of consultations undertaken by the UK Government and HMRC since March 2020, and we expect further consultation with the industry and advisers before the legislation is finalised for the FY22 Finance Bill. PwC will continue to engage with HM Treasury and HMRC over the coming weeks and months.

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CJEU's K and DBKAG Judgement

Introduction

A recent European Court judgement is likely to have important ramifications for alternative investment funds and the VAT efficiency of their procurement models.

The CJEU judgement was issued in respect of two co-joined cases, 'K' and 'DBKAG' and considered the fund management VAT exemption, in particular the extent to which the VAT exemption could be applied to the outsourcing by an investment manager of certain services in the context of special investment funds ("SIFs").

K (C-58/20)

The key issue in the case was whether outsourced tax accounting services (i.e. ensuring that the income received by unit holders from the relevant SIFs is taxed in accordance with the relevant law) can constitute a fund 'management' service for the purposes of the VAT exemption.

DB KAG (C-59/20)

The key issue in this case was whether the granting by a supplier to an investment management company (IMC) of a license to use specialist software, which was specifically designed for the management of SIFs, can constitute a fund management service for the purposes of the VAT exemption.

Given the specifics and similarities in the two cases, the two cases were joined.

CJEU Judgment

The judgment by the CJEU confirmed that the EU VAT exemption for the management of a SIF could apply to the services in question, providing that:

- these services are intrinsically connected to the management of SIFs, and
- they are provided exclusively for the purposes of managing SIFs.

Implications

This decision reaffirms earlier CJEU judgments that certain outsourced services can fall within the meaning of the term 'management', and therefore where they are provided in relation to a SIF, can qualify for VAT exemption.

This judgment also reinforces the decisions of the UK and European courts in BlackRock (C231-19), that supplies of specialist investment management software can also qualify for VAT exemption, and that exemption is not available where there are both SIFs and non-SIFs managed.

Whilst the decision in the joined cases specifically considered the services at issue, the decision is based upon VAT principles, and therefore VAT exemption also applies to other outsourced services which relate to SIFs, provided such services are specific and essential for and intrinsically linked to the management of a SIF. As such, it is important for asset managers of SIFs to identify which services are received, and to explore if the VAT exemption could potentially apply. The authors of this article consider that HMRC has historically applied an overly restrictive view of the term "management" in light of the EU jurisprudence, and it is to be hoped that this may now be an area which is revisited.

Whilst the UK has now left the EU and the CJEU judgements do not necessarily apply in the same manner, we are seeking to engage with HMRC to understand view on these cases, and whether there will be any change in the application of the fund management exemption in the UK as a result. We will provide updates on these discussions in future editions of this publication.

Further, it should be borne in mind that the decision will also apply in the EU27 – therefore for investment managers with fund ranges outside of the UK, the decision needs to be reviewed in the territory where the funds are located to consider whether there is scope for exemption to apply to any of the services received. PwC's European network of VAT and financial services specialists are in discussion with specific tax authorities, and again, we will provide relevant updates and developments in future editions.

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CJEU's K and DBKAG Judgement (continued)

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Next steps for alternative investment funds

The exemption for the supply of management services for a SIF is under review in both the UK and the EU, and the breadth of the term 'management' is likely to be considered in both reviews. In the UK, the Chancellor's vision for the future of FS in the UK was just recently published and included within that document was reference to the launch of the anticipated review of the VAT treatment of fund management.

It will therefore be important for all businesses to monitor the separate reviews closely in order to understand how the UK and EU may make changes to the VAT treatment of fund management services, and yet seek to preserve or enhance the competitiveness of their respective alternative investment funds industries. However, the recent decision from the EU court indicates that there should be an ability, based upon current rules, to revisit existing procurement models to identify VAT efficiencies.

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Why the UK Corporate Criminal Offence rules should still be high on the agenda for Alternative Investment Fund Managers

In brief

The UK corporate criminal offences ("CCO") rules have now been with us since their introduction in the 2017 Criminal Finance Act. In late May 2021 HMRC released latest information in respect of activities in policing and enforcing the CCO rules announcing there were 14 live investigations, another 14 cases under review and a further 40 cases that had been reviewed and closed with no further action being taken. A number of these cases relate to the financial services sector. This highlights that CCO is an area that is high on HMRC's agenda; when HMRC suspects that a tax evasion offence may have been committed, it will look at advisers and others who have provided services and consider whether the CCO can apply. In this article we look at some learnings that have arisen since the rules were introduced, current areas of focus for HMRC and what alternative investment firms should be doing to ensure that they comply with the rules going forward

Background

The CCO offences were introduced to address perceived difficulties in attributing criminal liability to relevant bodies (legal entities and partnerships) for the criminal acts of their employees, members, agents or those that provide services for or on their behalf ("Associated Persons"), who knowingly facilitate criminal acts of third parties. This is a strict liability offence and the only defence firms will be able to rely on is to demonstrate that they have reasonable prevention procedures in place to prevent the facilitation of tax evasion. The sanctions are severe, including a potentially unlimited penalty, a corporate criminal conviction, a public record of the conviction (and reputational damage), as well as potential regulatory censure. Firms are expected to carry out risk assessments as well as ensuring that reasonable prevention procedures are in place.

Learnings so far

Experience to date highlights some key learnings in respect of why CCO remains important as well as some of the pitfalls encountered in initially dealing with the rules.

Considering existing financial crime controls (e.g. anti-money laundering and anti-bribery and corruption) without applying a tax evasion facilitation lens has posed a challenge in dealing with the offence. It is crucial to appreciate that CCO is effectively a conduct / behaviour offence and it requires an understanding of broader conduct issues that goes beyond merely a financial crime perspective. Focusing on the underlying tax evasion risk rather than tax evasion facilitation has also been a common pitfall. Firms must also not assume that a low risk profile precludes the need for a risk assessment.

Some potential areas of risk for alternative investment funds include provision of assistance in connection with tax structuring, interaction with portfolio companies (in the case of PE), use of complex offshore structures, dealing with complex or innovative remuneration arrangements as well as the wide range of potential Associated Persons with whom they may interact e.g. other fund managers, employees who are directors of portfolio companies, coinvestors and certain advisors.

In light of these learnings, firms should reconsider their potential risks under CCO as well as take appropriate steps to ensure reasonable procedures are in place that are proportionate to the risks faced. It is equally important to address the evolving risk environment, and be in a position to deal with any potential scrutiny from HMRC going forward.

HMRC activity: increased focus

Whilst there has not yet been any charging decisions or prosecutions, HMRC has been active in considering the rules as part of its ongoing investigations into tax fraud and enablers of tax crime in general.

Why the UK Corporate Criminal Offence rules should still be high on the agenda for Alternative Investment Fund Managers (continued)

HMRC has said that the relevance and impact of CCO is more far reaching than many taxpayers will realise. No matter what the size of a business, or the type of service it provides, if there is a chance that someone associated with the business could knowingly facilitate a third party's tax fraud through their actions, then CCO is something that businesses should be aware of. HMRC is raising awareness of taxpayers' potential liability under the CCO legislation and ensuring that steps have been taken to profile and manage the risk of failing to prevent the facilitation of tax evasion. This is increasingly being explored via HMRC's new business risk review (BRR) process in addition to HMRC seeking specific meetings with alternative investment funds to discuss the approach they are taking to dealing with the CCO rules.

HMRC has also clarified steps it has been taking to embed CCO into its own process as well as potential approaches to enforcement. A large number of Customer Compliance Managers and Criminal Investigators have been trained on CCO and all existing suspected tax fraud or evasion cases are being considered in the light of the CCO offence in order to identify which parties may have been involved in the case and could have in some way facilitated the evasion in question. All of the criminal investigation powers and tools available to HMRC can be deployed when considering CCO. These include arrest and search warrants being issued without notice, dawn raids and confiscation of papers as well as the taking of witness statements.

What should Alternative Investment Funds focus on now?

We recommend that firms should ensure risk assessments have been carried out which are embedded in BAU processes and kept up to date for evolving risks as they emerge. Another important consideration is to ensure that, given the conduct nature of the CCO offences, organisations look to leverage their broader conduct and fraud prevention frameworks as much as possible when looking at the CCO offences.

Reviewing the completeness of 'reasonable prevention procedures' that have been put in place should also be a key focus. This includes governance, oversight and roles and responsibilities, training and communication from senior management, associated persons risk assessment and due diligence as well as staffing arrangements such as supervision and segregation of duties.

Since the risks faced cut across organisational boundaries, it is vital to ensure an appropriately defined operating model is in place between front office / client facing teams, compliance teams and the tax function to effectively and efficiently address the risks faced with the required control arrangements.

Finally, firms should evaluate the monitoring and review activities that have been defined. This is particularly important in terms of ensuring the firm's approach is fully embedded, and subject to ongoing scrutiny and review by appropriate levels of management.

Next steps for alternative investment funds

HMRC's focus on the CCO rules is evident in terms of investigation activity, approach to identifying potential cases, as well as steps taken to actively encourage businesses to consider how CCO may affect them. Firms should ensure that their approach to addressing CCO risks remains current and subject to regular review. This is particularly important given the first interaction a firm may have with HMRC may be in addressing questions as part of a live investigation. Key factors to consider include:

- The extent to which risk assessments are embedded into BAU activities;
- Leveraging existing approaches to mitigating conduct and fraud risk;
- Ensuring appropriate controls are in place and operating effectively; and
- Putting in place appropriate monitoring and review procedures.

Recent HMRC activity makes it clear that the focus on CCO is here to stay.

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EU business tax communication

The EU Commission published on the 18 May a communication to the EU Parliament and EU Counsel their proposed tax agenda for the 21st Century to reflect the various challenges the EU and the international community are faced with including the impact of the pandemic and the green and digital transition. The communication was titled the "Business taxation for the 21st Century".

The communication summarises proposed reforms to the EU tax framework and the Commissions support for international tax reform, with the main takeaways being:

- The Commission confirms their support for the OECD's Pillar 1 and Pillar 2 proposals to address the tax challenges of the digital economy. These have recently gained the support of most countries in the OECD and the G20. They propose to implement this via an EU Directive once it's in agreed form. They recognise that this could impact existing EU Directives such as ATAD 1 & 2, for example with respect to the CFC rules, and the EU Interest and Royalties Directive.
- A framework for a common corporate tax system for EU Member States is proposed to be implemented by 2023, referred to as the "Business in Europe: Framework for Income Taxation" or "BEFIT". This is intended to create a common tax base for businesses within the EU with a formulaic method used to allocate profits between Member States. The formulaic method is intended to reduce the need to rely on conventional transfer pricing principles.

  The expectation is that countries would then be able to apply their own corporation tax rate to the allocated tax base. This is a very ambitious proposal, and previous attempts (the Common Corporate Tax Base CCTB) have failed to materialise. Such a proposal would need to align diverse tax systems and to have the political support from all Member States, which is a tall order.
- Digital Levy proposals are due in July 2021 which are focused on sales rather than net income and are intended to apply independently to the rules from Pillar 1 and Pillar 2. This is counter to the commentary in Pillar 1 which states that Pillar 1 is intended to replace digital levies. The levy is expected take a similar form to the UK Digital Services tax and be targeted towards the largest digital businesses.
- The Commission has begun a consultation on the misuse of shell entities which is underway with the deadline for responses due on 27 August. New measures are expected to be implemented by the end of 2021. The Communication is light on details with no examples and it's not clear how they are viewing this in the context of investment holding structures. They may just reinforce the principles from the Danish Beneficial ownership cases, or they may go even further with more prescriptive requirements on what a holding company must have/do in order to be considered to have sufficient economic substance e.g. functions performed, employees, premises etc.
- Proposals are due in July 2021 for a Carbon Border Adjustment Mechanism (CBAM), a digital levy and a revision of the EU Emissions Trading System.

Next steps for alternative investment funds

This Communication has some ambitious and potentially significant changes impacting European businesses in the medium term, and in the shorter term we expect more clarity on some potential new measures such as those counteracting the use of shell companies which could impact investment holding structures. We will continue to provide updates on each as they progress, and in the meantime if you have any questions please feel free to contact one of the team shown here or your regular contact.

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Global operational taxes update

As alternative investment funds continue to battle the operational taxes impact of Brexit, we're seeing more and more challenges presented by changing domestic legislation across the EU and beyond.

Managers are paying close attention to the constantly changing rules and regulations around operational taxes to ensure that they're accessing the correct rates of Capital Gains Tax ('CGT'), Transaction taxes and Withholding Taxes ('WHT') across their fund range and asset base. Taking timely action to ensure that you have the correct mechanisms in place to access those rates can be crucial to your funds' competitiveness.

Below, we list just a few of the many developments we're seeing in the world of WHT.

Spain

Spain has often presented challenges for EU/EEA funds attempting to avail themselves of beneficial WHT rates by applying the principle of free movement of capital.

After positive decisions for US-regulated investment funds investing (with a less than 10% holding) in Spanish equities, new precedent is being set in the world of Spanish WHT. Non-Spanish Sovereign Investment Funds ('SIFs') now have reason to believe that they will be eligible for a zero percent WHT rate on portfolio dividends from listed company shares.

In March, the Spanish Supreme Court issued a judgement to confirm that, in parity with domestic, state and public pension funds, non-Spanish SIFs can access a zero percent WHT rate on the dividends due from its portfolio of Spanish listed equities.

The Spanish Supreme Court's judgement confirms the judgement that was previously made by the Spanish national court. The Supreme Court's judgement is based on the principles of EU free movement of capital, meaning that the consequences of the ruling are far reaching as it will impact not only EU/EEA domiciled funds, but also third country funds.

Netherlands

On 9 April 2021, the Dutch Supreme Court published its response to the prejudicial question raised by a lower Court to a Fokus Bank claim filed by a UK unit trust. The question is about the compatibility of the remittance discount under the Dutch Fiscal Investment Institution ('FII') regime as applicable from 1 January 2008.

By way of reminder, up until 31 December 2007 a Dutch fund would receive a refund for Dutch dividend WHT if the FII conditions were met. The Courts ruled that a foreign fund can apply for a refund of Dutch dividend WHT if it makes a voluntary payment of Dutch WHT on its distributions to investors. The change at the beginning of 2008 resulted in Dutch funds no longer being able to access refunds of Dutch WHT. Rather, from then on, they would receive the same treatment as foreign funds but thereafter receive a credit for WHT paid on income paid to investors.

Decision

The Supreme Court's decision rules that the remittance discount is not comparable to a refund of WHT and therefore cannot lead to a refund of WHT to foreign funds comparable to a Dutch FII.

Impact

The Supreme Court's ruling concludes that the remittance discount and refund mechanism are materially and economically different. Neither Dutch nor foreign firms are entitled to a refund of Dutch dividend WHT, so the remittance discount cannot lead to a refund of WHT to foreign funds due to the differences of the mechanism. They state that difference is a result of different tax regimes and is not discrimination against foreign funds.

This decision from the Dutch Supreme Court closes the door to a potential referral to the CJEU and sets a strong precedent for claims currently filed and pending with the tax authorities or being litigated in the Dutch courts.

Foreign investment funds should give careful consideration to the viability of submitted claims in the Netherlands, where the claim is comparable to a Dutch FII with respect to income derived after 1 January 2008.

Global operational taxes update (continued)

France

France has received a letter from the European Commission ('EC') asking for the nation's WHT rules on dividends paid to 'Unit-Linked Insurance' companies in other EEA Member States to be changed.

Unit-Linked Insurance policies are a type of life insurance where the premiums of the policy-holder are used to purchase units in a fund of that person's choice. The dividends paid out by those funds are passed on by the insurer to the policy-holder.

Unit-Linked Insurance companies established in EEA Member States are required by law to pay a final WHT on French dividends received.

As alternative investment funds managers continue to battle the operational taxes impact of Brexit, we're seeing more and more challenges presented by changing domestic legislation across the EU and beyond.

However, this is not in line with how French law approaches Unit-Linked Insurance companies established in France, which is that they either pay no WHT on French dividends received, or they can credit the WHT paid against French corporation tax, which amounts to zero as the funds have to write large provisions to cover clients' potential insurance claim.

The EC's communication deems that the rules infringe on the principle of free movement of capital. Spain

Italy

Development

Italian borrowers are exempted from applying WHT to interest and other loan-related payments to lender banks that are resident in an EU Member State. The Italian tax authorities recently announced that this exemption has been extended to British banks throughout the Brexit transition period (1 February 2020 to 31 December 2020), which was put in place to ensure that until the end of 2020 the core principles of the EU remained relevant in relation to the UK.

Therefore, the Italian tax rules applicable to the UK's membership in the EU prior to Brexit continue to apply until the end of the Brexit transition period.

Impact

As this clarification was only released in April 2021, after the end of the transition period, it may be that Italian debtors were withholding tax on interest payments made to UK banks throughout the transition period. Given that the Italian Tax Authorities have now clarified that such payments should have been free of WHT, it may be that there are refund opportunities for UK banks.

Sweden

Similar to the issues raised in relation to France, Sweden has also been the recipient of a letter from the European Commission ('EC') regarding the potential incompatibility of Swedish domestic legislation with EU law on the taxation of dividends paid to public pension institutions.

As you might expect, given the nature of their business, Swedish public pension funds are entirely exempt from taxation. Conversely, dividends paid by Swedish resident companies to equivalent non-resident public pension institutions are subject to WHT. The rate of WHT is generally at the rate of 15% as many companies are able to avail themselves of the reduced rate afforded to them via the double taxation treaties concluded between Sweden and other EU/EEA countries.

The EC is of the opinion that treating dividends paid by Swedish companies to foreign public pension institutions less favourably than similar dividends paid to domestic public pension funds may infringe on the principle of the free movement of capital.

Next steps for alternative investment funds

This group of developments should serve as a timely reminder that, even without considering the impact of Brexit, keeping up to date with the continuously evolving case law in the European operational taxes space will allow alternative investment funds both to anticipate potential tax leakage and to take advantage of positive rulings.

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Long term asset funds – Worth the wait?

In the recent HM Treasury consultation document, calling for input on a review of the UK's fund regime, the Treasury noted that a working group had been established to further consider recommendations to establish a Long-Term Asset Fund ('LTAF').

The LTAF represents a motion for a new authorised open-ended fund structure, most likely in the form of a QIS-type fund, that will be designed to enable investors, particularly DB/DC pension schemes and life companies, to more assuredly invest in illiquid assets (such as venture capital and infrastructure). The current additional benefit of the LTAF is the possibility of it supporting several wider UK government priorities, particularly the work to address the financing gap for firms trying to scale up and to help drive the post-COVID economic recovery. So, it's perhaps not so surprising that it has come to the fore right now. Following discussion with HM Treasury, the Bank of England, the FCA and TPR, UK PLC has an ambitious target of seeing the first one established in 2021.

In order to establish a new LTAF, the FCA is proposing to create a new category of authorised fund, with its own chapter of handbook rules. The principles-based framework is designed to provide flexibility on the assets LTAFs can invest in, along with appropriate protections for investors. These protections are expected to include longer redemption periods compared to other fund structures, higher levels of disclosure, and specific reporting and liquidity management tools (e.g. the ability for managers to use notice periods on redemptions and subscriptions, and to defer redemptions), and governance features. Only firms that are authorised as full-scope UK AIFMs would be able to manage LTAFs. At the time of writing, the FCA has initially suggested restricting distribution of the LTAF to professional investors and sophisticated retail investors, although it is possible this access will be widened in the future.

Investment powers

It is presently envisaged that the investment powers of any new UK LTAF would likely be modelled on the existing rules for Qualified Investor Schemes (or 'QIS funds').

To secure an appropriate degree of consumer protection for investors in LTAFs, we understand that any new UK LTAF will be required to have a prudent spread of risk. This is the standard expected of a UCITS or a Non-UCITS Retail Scheme ('NURS'). A QIS simply has to have a spread of risk. In guidance, the FCA sets out that they consider that a manager of any new UK LTAF should consider whether the fund's exposures are sufficiently diversified, including, where relevant, exposures to underlying investments through structures such as holding companies or CIS. The FCA also sets out that they will expect a prudent spread of the different risks to which an LTAF is exposed. At the time of writing, it seems likely that LTAFs should have 24 months to achieve diversification.

It is currently planned that funds will be permitted to invest in loans in addition to the assets permitted for a QIS. Such loans will be required to meet certain conditions, for example that they are not made to individuals or affiliated parties, and that they do not give rise to any conflict of interest. Private credit funds, of course, already invest in loans, and there are some concerns that the existing QIS rules do not necessarily permit investments in all appropriate loan types.

Those of you with a tax background will be mulling over the possibility of commodities, property, debt and syndication. Clearly, there could be tax issues if an LTAF's activities would amount to a 'trade' for tax purposes and this is something that will need to be alleviated. We understand – but we don't know the stage of discussion – that the FCA has recognised this issue and is engaging with HMT and HMRC in this respect.

Interestingly, the FCA intends to enable LTAFs to invest in other CIS in a way that is somewhat less prescriptive than the existing requirements on investments in second schemes for QIS. You will recall that under the current QIS rules, managers have to establish that a CIS will not invest more than 15% of its assets into another CIS. However, in order to enable the efficient exposure to a diversified portfolio of private assets, we understand that the FCA intends to enable LTAFs to choose to invest in CIS that themselves invest in other CIS, on the condition that the manager makes reasonable efforts to ensure a scheme does not indirectly invest into itself. Clearly, local CIS may be the most tax efficient way to access private investments in some overseas jurisdictions. Some private investments may also be structured as CIS to enable a sufficiently diversified portfolio of investments. The restriction on investing in second schemes also reduces the risk of layering of costs and charges within a scheme.

Long term asset funds – Worth the wait? (continued)

Anyone that has ever been party to any debate on the UK's offshore fund regime reform will be thinking about what fund of funds arrangements really mean in respect of the future tax profile of a potential LTAF. We have the very limited margin of error on RFS calculations after all, because of HMRC concerns about the multiple fund structures being used to roll up income offshore. The UK's offshore fund rules, and the possibility of a dreaded dry tax charge may be of interest here. Even outside of this immediate concern, there are likely to be some interesting considerations from a UK investor tax perspective due to the nature of the underlying assets. Valuations and reporting in the infrastructure and private equity space can be complex given the application of the unlisted trading companies exemption and the niche returns that are derived.

GDO limitations?

In case a QIS model (or a QIS-like model) is taken up, it is worth remembering that the current QIS regime requires genuine diversity of ownership ('GDO') requirement to be satisfied, as otherwise investors are taxed on dividend distributions and gains in the same way as distributions from other companies. Ordinarily there are good reasons for adopting a GDO condition, however it could limit the use of a LTAF in the same way as it currently restricts QIS, as it would prevent wealthy families/family offices from using the LTAF regime (but perhaps that was the point!). Given the objectives of the LTAF are to encourage investment in long-term investments linked to infrastructure we wonder if the government will consider making an exception for the GDO condition for particular asset classes (i.e. a 'white list of good investments') where in the absence of the private investment funding it would fall to the government.

Long term asset funds – Worth the wait? (continued)

Issue with mixed investor types?

There has been some suggestion that the new LTAF could be constructed as an Authorised Contractual Scheme ('ACS'). Whilst ACSs have been hugely successful, this has been the case only in instances where investor types are almost entirely homogeneous (e.g. all UK DB pension schemes). This is the case as it's simply too complex for administrators to stream income with different tax statuses (tax note lovers of TRACE!). As such, if LTAFs are to appeal to a wider population than large UK institutional investors, an ACS may not be the best option.

Use of intermediate holding companies

Intermediate holding companies, which are sometimes used for private assets, may well be permitted in an LTAF provided certain conditions are satisfied and the investment aligns with funds specified objectives. We also note, in this context, that there may be tax issues around holding companies and that there is a separate discussion ongoing in this space, and we at PwC have submitted a response to HMT's consultation on the future of the UK Fund Regime.

Timings

The FCA recently published CP21/12: A new authorised fund regime for investment in long-term assets. The consultation is open until 25 June 2021, and the FCA plans to publish a final policy statement later this year. The FCA's Productive Finance Working Group is due to draw its conclusions in July 2021.

Next steps for alternative investment funds

Alternative investment funds should consider whether the outlines create any strategic opportunities to use the LTAF structure as a vehicle to invest in illiquid assets (e.g. venture capital, private equity, private debt, real estate and infrastructure). In this context, they should consider how this proposed structure might be able to deliver better investment outcomes for their clients, and consider new product development opportunities. The tax structure of LTAFs of course remains critical to ensure the success of the proposals. Helpfully, the FCA has been engaging with HMRC from an early stage and HMRC asked questions about LTAFs in its recent deliberation on the future of the UK Funds industry. How much you can do and how flexible these vehicles may ultimately be will depend on the eventual determined balance between the potential benefit of the LTAF to support several wider UK government priorities and perceived concessions on tax matters such as trade risk and diversified ownership requirements.

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