Keeping up with Alternative Investment Funds

May 2022

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Introduction

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

Our May newsletter looks in depth at a number of topics ranging from practical impact of BEPS Pillar 2 for alternatives to employer-related reporting.

This month we have prepared an article on new disregard rules in relation to deals contingent forwards that came into force on 1 April 2022, as well as a detailed analysis of corporate substances rules and their interaction with the proposed European ATAD III Directive.

We have also included a few news pieces on the next slide that may be relevant in the context of alternative investment funds.

See the full list of articles in this newsletter below:

- Corporate Substance - time to get it right
- OECD BEPS Pillar 2 and practical impacts for Alternative Investment Fund Managers
- Employer year-end reporting
- Reporting of carry and co-invest - 'Form 42'
- Deal Contingent Forwards - Disregard Regs

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

Venture Capital consultation

On 28 April 2022, the Treasury Committee launched an inquiry into exploring the state of the UK's venture capital industry. Of interest to the Committee is the ability of firms to source financing to scale up, how start-ups and established industry cooperate, and the effectiveness of tax incentives.

Furthermore, the inquiry follows the UK Government's work on its "levelling up" agenda and achieving carbon net zero, and it will be interesting to see how the venture capital industry plays its part in all of this. We plan to respond to the Call for Input in due course, but for those interested the Committee is welcoming any submissions of potential changes, proposals, and relevant statistics before 7 June 2022 and you can respond here.

New Hybrid Entity Disclosures for Corporate Tax Returns

The company tax return has recently been revised to include a new version of the CT600B (along with revised CT600 guidance), which now requires a number of new disclosures relating to the Hybrid rules. There are ten questions requiring consideration.

In particular, we note that this means that groups will now need to determine which entities are hybrid entities, even if there are not any mismatches or counteractions. This is a large additional burden for taxpayers. We are currently in consultation with HMRC to understand the position in relation to some of these disclosures, but the strict requirement is for the updated CT600B to be included with all returns submitted to HMRC from **6 April 2022**.

Corporate Substance - time to get it right

In most transactions, value comes to be realised when a company is sold and in certain cases (e.g. private equity), proceeds distributed to investors. Frequently, it is expected that a combination of local tax exemptions and double tax treaties will eliminate tax on gains and distributing the proceeds to investors. However, the landscape is changing radically and groups not moving with the times could face a real erosion of value.

Corporate substance to support tax treaty claims has long been talked about. We explain why tax authorities see this as important, even though it is not a feature of tax treaties, and how the EU ATAD 3 directive will test substance and cause issues for entities lacking it.

In recent years, tax authorities have been tackling the use of abusive and aggressive tax structures by companies operating across borders. As a result, there has been an increasing focus on companies having 'substance' from a tax treaty perspective. This is interesting as 'substance' doesn't really feature in existing tax treaties. However, as set out below, this increased focus on substance is understandable.

Traditionally, access to treaty benefits depended on two things:

- Residence in a treaty state.
- Beneficial entitlement to the income or gains in question.

This opened the door to 'treaty shopping' - where a company in jurisdiction A, which does not have a tax treaty with jurisdiction B, inserts a flow-through or conduit Special Purpose Vehicle ("SPV") in jurisdiction C, which does have a favourable tax treaty.

Accordingly, more recently and in particular through the BEPS multilateral instrument, there has been a third requirement for companies to be eligible for treaty benefits:

- 'Purpose', i.e., if the main reason for being resident in a country or holding the asset is to obtain treaty benefits, then that is not acceptable.

Substance though, has not been an overt feature of treaties to date.

Why substance?

If a tax authority is looking to filter out the abusive use of treaties, it is not difficult to see the problems with the above. Most non-tax-haven jurisdictions want companies to be resident. It helps collect tax. Residence is often given based on incorporation, and so is not an obstacle to obtaining treaty benefits. Beneficial ownership and purpose are better filters, albeit they require subjective judgements.

The attraction of substance is that it is tangible, it allows filtering by objective tests. In short, if a company is light on substance, this acts as an indicator that all may not be well on the purpose and beneficial ownership stakes. What this effectively means is that the first use of a substance test is as a 'warning flag'.

It is a step beyond this to use substance as a stop flag. To say that where you lack substance you are not entitled to treaty benefits introduces a distinction between domestic residence (local taxation) and treaty residence (reduction of cross border taxation).

Practical examples

Within the EU, the February 2019 'Danish Cases' (the company names were never given) led the way in considering a holding company's entitlement to Directive benefits for dividend and income withholding tax (WHT). While these cases focussed on beneficial ownership and abuse of rights, they did set out parameters for identifying conduits which included:

"The absence of actual economic activity must, in the light of the specific features of the economic activity in question, be inferred from an analysis of all the relevant factors relating, in particular, to the management of the company, to its balance sheet, to the structure of its costs and to expenditure actually incurred, to the staff that it employs and to the premises and equipment that it has."

Although only a small part of the EU Court of Justice ruling, these tests are reflected in later thinking.

In addition to treaty benefits, sometimes domestic exemptions are also available. The Netherlands will give a domestic exemption to certain cross border payments of dividends for example, to the UK, which is now outside of the EU. However, in giving this exemption, they will apply the Netherlands local substance tests. These include an expectation of local bank accounts, local office premises, local bookkeeping, EUR100k of employee expenses as well as local competent directors.

Corporate Substance - time to get it right (continued)

Surprisingly, these tests are effectively imported into the UK/NL tax treaty where the anti-abuse provision of the MLI is included. In considering this, the Netherlands have said they will apply the same abuse tests, and thus substance requirements, as they do for the domestic rules. The MLI gives the Netherlands the final call on treaty entitlement in an unfortunately worded phrase:

"The competent authority of the [Contracting State] to which a request has been made under this paragraph by a resident of the other [Contracting State] shall consult with the competent authority of that other [Contracting State] before rejecting the request."

Therefore, we can see a substance test already being applied to deny relief.

And so to ATAD 3 – the 'unshell' directive

The EU and OECD have provided tax authorities with various instruments such as the Anti-Tax Avoidance Directive (ATAD), and the Multilateral Instrument to help combat tax treaty abuse. However, since entities with minimal substance and economic activity are supposedly still used for improper tax purposes, the European Commission recently issued a new proposal (ATAD 3).

Taking a step back, we can see that there is a spectrum of substance:

- Use of a third party domiciliation agency.
- A couple of local professional directors, and perhaps a contract to hire two desks and three filing cabinets whilst outsourcing company secretarial matters.
- A small in-house office shared between many companies.
- Substantial functions directly employed in-country by the company.

The proposed EU ATAD 3 Directive sets out a number of filters to identify those companies with low economic substance. One target is companies whose management is outsourced. Unless low substance companies can justify their position, the local tax authorities will not issue tax residence certificates, which will likely preclude third countries giving treaty benefits and EU directive benefits will automatically be denied. Even if they can justify their position, they will need to disclose substance information in their tax returns. This information will be available to all EU countries, and any EU state which suspects an entity lacks substance can ask for an audit of its return.

The ATAD 3 indicators are not unfamiliar; employees, premises and qualified local directors. However, as things stand, the directive contains some fundamental flaws, for example:

- A derogation based on the undertaking having at least five full-time equivalent staff exclusively carrying out the company's income generating activities.
- A substance requirement based on the company having its own premises, or premises for its exclusive use.

Setting aside what would constitute premises (the toilets, kitchens and entrances discussion) quite simply, these do not reflect typical modern business practice. A high substance multinational or Private Equity ("PE") platform will often have that substance 'in country' but not 'in company' for each specific SPV. The draft Directive follows the Dutch approach and allows you to look up to a same country parent for substance but not across a chain or, for a PE house, to a house management company.

These defects can be remedied, and may well have been at the time of reading. ATAD 3 then becomes a viable route to flagging companies meriting further investigation. Those companies not exempt, or able to avail of a derogation must report details of including, but not limited to:

- Premises
- Revenue
- Expenses
- Activities
- Directors residence and qualifications
- Outsourced activities
- Bank accounts and who can issue payment instructions.

Corporate Substance - time to get it right (continued)

Being positive, ATAD 3 could be a route to providing clear guidance on substance and common benchmarks across Europe. However, 'gaming' the rules is unlikely to be successful. To take an example, the requirement is to report: "bank account number, any mandates granted to access the bank account and to use or issue payment instructions". A low traffic account, or an account in an EU country where payment instructions are issued from London will simply not pass muster. The Directive requirement is to provide "documentary evidence" in support of the substance.

So ATAD 3 is likely to achieve its goal of defining substance within Europe, and providing a means for comparing across peers. The press release accompanying the first draft Directive promises something similar to address abuse outside of the EU. Whilst hairs may bristle about impinging on tax treaty rights, many already consider the draft ATAD 3 does that and as shown in the Netherlands/UK example, that is quite possible.

Reacting to ATAD 3

Realistically, ATAD 3 does not tell us anything new. For both PE and corporate investors it merely accelerates an existing process of either bolstering substance in a jurisdiction or relocating. The middle ground is simply disappearing. For PE - the UK Qualifying Asset Holding Company ("QAHC") regime offers an alternative platform, but for corporates, it is not available. Furthermore, having regard to the intention to act against non-EU shells, it would be wise to look at the ATAD 3 substance criteria and ensure your UK or other holding companies meet this.

At the risk of sounding like every other ATAD 3 article, it is important that groups review their structures now, and make decisions on holding company locations and /or explore structures which do not rely on treaty/directive benefits.

Objective tests - where next?

We have flagged that 'substance' has not been an historic treaty requirement. It is a proxy for residence and beneficial ownership that can be measured by objective tests. It is not a proxy for 'purpose'. No amount of 'substance' can make good a bad 'purpose'.

In recent times, the EU has become increasingly attracted to objective tests to flag abuse. DAC 6 reporting is an example. If that, and ATAD 3 are successful, perhaps this could be extended? If we revisit the 'Danish Cases' - these were primarily about beneficial ownership. They set out a number of useful tests. These include whether the recipient of dividends is contractually or economically bound to pass these on, whether in practice they almost always do etc. It does not seem too big a stretch to extend ATAD 3's formulaic approach to encompass beneficial ownership. Purpose remains a subjective test, but those entities with poor purpose will quickly be identified.

Next steps

- Overall, there is a clear direction of travel and the pace is picking up. The OECD's BEPS report on Treaty Abuse was published in October 2015 and despite the many naysayers, much was achieved quite speedily via the Multilateral Instrument.

In the 2020s it seems likely that the EU will be leading the way, and the use of shell entities to gain treaty benefits has a very limited lifespan. Companies should be planning on this basis.

Gareth Hughes
Partner
M: +44 (0)7766 732921
E: gareth.hughes@pwc.com

John Holt
Director
M: +44 (0)7808 633235
E: john.holt@pwc.com

OECD BEPS Pillar 2 and practical impacts for Alternative Investment Fund Managers

Overview

BEPS Pillar 2 represents a significant change to how large multinational businesses calculate and pay taxes globally. The new regime brings numerous financial, technical, accounting, data and technology, and compliance and reporting challenges. So while the first tax compliance filings are still some way off, tax and finance teams should be taking action now to conduct impact assessments and to put in place appropriate implementation programs.

Pillar 2 is a key element of an ongoing transformation of the global tax system under the Base Erosion and Profit Shifting ('BEPS') project led by the Organisation for Economic Development ('OECD'). With its key element being implementation of a global minimum effective tax rate of 15% on a country-by-country basis, it presents significant technical and operational challenges for in-scope alternative asset managers.

The key features of Pillar 2 are:

1. Application to all multinational groups with turnover in excess of EUR 750m. This mirrors the thresholds for Country by Country Reporting ('CBCR').
2. Two interlocking rules that are together known as the Global anti-Base Erosion ('GloBE') rules: the Income Inclusion Rule ('IIR') and the Undertaxed Payment Rule ('UTPR'). In practice, these are complex calculations and there are likely to be a plethora of domestic implementation challenges, due to areas of uncertain technical interpretation in the OECD model legislation and uncertain interaction with existing or planned local territory domestic minimum tax regimes.
3. Top-up of the tax liability for 'low-tax' countries to reach the 15% minimum rate. This is already leading to many lower tax territories assessing the need to increase their domestic tax rates to meet this baseline, including Ireland, Switzerland and Jersey.

Impact on alternative funds

Fortunately, the OECD have listened to industry representations and introduced a broad-based carve-out for 'investment funds' designed to preserve the general tax-neutrality of funds. However there are a number of conditions which need to be met in order to fall within the funds carve-out, relating to regulation, management and investment strategy. Carve-outs also apply to 'investment entities', being entities owned at least 85% by funds or other 'Excluded Entity' investors (including pension funds, sovereign wealth funds and charities) and which exist to hold assets or invest funds on behalf of those investors.

However one note of caution - this exclusion of funds does not apply where the fund is itself consolidated into another group's financial statements (such as an asset management or insurance group). It also does not have blanket application where a fund is self-managed (i.e. owns its own investment manager) - in this case Pillar 2 may still apply to the 'trading' investment management element of the funds activities.

While it is to be welcomed that most alternative investment funds and their subsidiaries will therefore fall out of the regime, either based on the turnover threshold or the above sector exclusions, work will be required to ensure that all the conditions are met and to document this on behalf of funds boards and investors. Particular care will need to be taken in respect of 'anchor investors' and 'fund-of-one' structures, where the size of an investor's stake in the fund might trigger a requirement for the fund to be consolidated into the investor's own financial statements, potentially bringing Pillar 2 back in scope.

Impact on alternative asset managers

Any firm that expects to meets the EUR750m turnover threshold in 2022 or 2023 will need to put in place a comprehensive plan to assess the potential impact on the group, consider potential structural changes and ensure the right level of internal and external resources to achieve robust compliance with the Pillar 2 regime.

The OECD has already produced model legislation and is targeting a start date of 1 January 2023 for IIR and 1 January 2024 for UTPR, requiring local territory implementation to be delivered in the next 18 months. Any material tax impact will likely need to be assessed and disclosed as soon as draft legislation is published in relevant jurisdictions - initial reporting therefore could be as early as the 2022 financial statements (i.e those published in early 2023).

OECD BEPS Pillar 2 and practical impacts for Alternative Investment Fund Managers (continued)

The impact of Pillar 2 is likely to be most significant for Alternative Investment Fund Managers in the following areas:

1. Uplift of the tax rate in any lower tax territories to 15%, impacting the group effective tax rate in a single period.
2. Potentially complex changes to the group deferred tax position resulting from a requirement to recognise all deferred tax at the lower of the country rate and 15%. This can drive potentially odd outcomes especially in 'high-tax' tax jurisdictions where top up tax may be due even if the territory is loss making.
3. Potential double taxation where the group has a significant US structure, resulting from uncertainty over how the US Global Intangible Low Tax Income ('GILTI') rules will interact with BEPS Pillar 2. A worst case scenario would be that both Pillar 2 top up taxes and US GILTI are paid in respect of the same profits.
4. Dealing with the impact of funds consolidated into the asset manager's own balance sheet, which could arise for a number of reasons including funds seeded to establish track record, illiquid 'side-pocket' holdings remaining after redemption of external investors, or fund holdings held to hedge phantom fund awards made to employees.
5. Cost of compliance - as well as compliance with Pillar 2 reporting itself, the proliferation of domestic minimum taxes being announced as a policy response to Pillar 2 will increase the volume and complexity of tax compliance.

As well as the potential financial impacts and technical challenges that Pillar 2 brings, at a practical level there will be major tax reporting and compliance challenges resulting from the need to collect, manipulate and report financial data on a new basis in each of the territories in which the group operates. This includes:

1. The need to break out consolidation / elimination adjustments to ensure that Pillar 2 amounts are allocated to the correct entity / territory.
2. Running parallel provisioning calculations within the year-end reporting timetable.
3. Obtaining financial and accounting data at a level of materiality required for tax compliance. Most accounting systems and processes will be at a group level of materiality so a more detailed breakdown may be challenging to gather.
4. Calculating the tax specific adjustments required for Pillar 2 reporting at a GLoBE and territory level. This includes complex bespoke calculations for share based payments, unrealised gains, and accrued pension expenses.

OECD BEPS Pillar 2 and practical impacts for Alternative Investment Fund Managers (continued)

So how should the alternatives tax function go about getting Pillar 2 ready? There are some practical steps all tax teams should be taking now to ensure they are ready for the new regime:

1. Undertake an initial impact assessment modelling exercise. Understanding and gathering the data that will be required for Pillar 2 reporting is critical in assessing the potential impact on the group's tax position. Perhaps more importantly, It will also identify any technical or policy uncertainties and data or process gaps that will need to be remediated in advance of reporting.
2. Review and address any **structural issues** arising. To the extent that there are significant top-up taxes due in any locations, evaluating potential changes in operating models or tax structure will take time to assess and implement in advance of the effective implementation date.
3. Review fund and managed account structures to confirm **investment fund/entity exclusions** apply, develop responses to investor DDQs and consider changes required to planning process for new funds.
4. Develop a **robust compliance and reporting strategy** for Pillar 2. As noted above, there are a myriad of accounting, process, and data challenges arising from the new regime. This will involve engaging with in-house finance, risk and technology teams, as well as external compliance providers to ensure the impacts have been understood, data and resource requirements addressed and filing responsibilities allocated.

Next steps

- Alternative asset management firms should engage now with the Pillar 2 regime to ensure that the financial impacts can be assessed.

There are technical, accounting, process and data, challenges that need to be addressed ahead of the first reporting period.

Tim Hill
Partner
M: +44 (0)7734 958732
E: tim.hill@pwc.com

Stuart MacPherson
Director
M: +44 (0)7703 562384
E: stuart.t.macpherson@pwc.com

Employer year-end reporting

The end of another UK tax year means employers and payroll managers once again have a flurry of activity to meet their HMRC compliance obligations for 2021/22.

There are a number of deadlines in close succession and whilst your payroll provider is likely to handle a lot of the requirements on your behalf, it is important that you are aware of the various deadlines so that you can maintain oversight and ensure that information is fully and correctly reported.

By the middle of May you will have already have undertaken:

- Agreeing with HMRC any benefits that you would like to process through **payroll voluntarily** rather than putting on a P11D
- Your **final payroll submission** for the 2021/22 tax year which includes your Full Payment Submission and your last opportunity to make any in-year adjustments to payroll
- Any **Earlier Year Updates** for 2021/22 that you did not already process via your March payroll adjustments

There are a number of further deadlines to have in mind over the coming weeks and months.

31 May – Form P60 to be given to employees summarising their total pay and deductions.

31 May - Annual STBV report ('Appendix 4') reporting business visitors to the UK who will qualify for exemption from UK income tax under the terms of a double taxation agreement that the UK has with another country. The precise information to be reported will depend on the number of days each individual has spent in the UK during the 2021/22 tax year.

31 May - Annual special STBV arrangement ('Appendix 8') to report UK earned income and pay taxes in respect of business visitors to the UK for up to 60 days from non-treaty partner locations or from overseas branches of a UK company.

Note on business visitors - it is important that you monitor your global business travel in order to help you stay compliant from a regulatory perspective, to manage corporate tax permanent establishments, and to stay on top of your payroll reporting obligations.

4 July – The last date for employees to reimburse any PAYE that employers have thus far paid on their behalf – for example on notional payments – to avoid any additional tax charges arising.

5 July – Last date for agreeing any new items that an employer wants to include on their PAYE Settlement Agreements ('PSA'). PSAs are used for employers who wish to settle taxes on certain benefits in kind on their employees' behalf. Only items that are minor, irregular or impracticable can be included on a PSA and the taxes and NIC due must be settled on a grossed up basis.

Employer year-end reporting (continued)

6 July – Form P11D to be finalised and provided to employees, along with filing of P11D(b) with HMRC – along with the calculation of employer NICs – reporting benefits in kind either not reported on the PSA or not covered by an exemption. Consider, in particular, any additional items made available to your employees as a result of the COVID-19 pandemic.

6 July – Online reporting of chargeable events relating to Employment Related Securities ('ERS') which could include award, vest and exercise of restricted shares awards, stock options, carry instruments and co-investment units to former, current or prospective employees. Reporting must be provided even if there are no corresponding tax charges. See overleaf for more detailed information about reporting of carry and co-invest.

6 July – Notification of termination payments to HMRC along with explanation of the tax treatment.

22 July – Payment of NICs calculated on benefits in kind on the P11Ds.

31 July (/1 August) - Submit calculation of income tax due in relation to PSA

22 /24th October – PSA payment deadline including the tax and grossed up NICs.

Please note that additional reporting requirements may arise if you operate Modified PAYE or NIC schemes, or if you utilise Net of Foreign Tax Credit arrangements. Please reach out to your usual PwC team or the contacts below if you have any queries.

Next steps

- Confirm with your payroll providers which items they will handle for you
- Review all payments made to or on behalf of individuals and expenses reimbursed to ensure that taxable items are recorded
- Review your business visitors to the UK and obtain necessary information for both of your STBV submissions

Leena Malde
Senior Manager
M: +44 (0)7850 516334
E: leena.malde@pwc.com

Sam Moore
Director
M: +44 (0)7843 440171
E: sam.j.moore@pwc.com

Reporting of carry and co-invest - 'Form 42'

Key messages:

- Online report due for submission – 6 July 2022.
- Awards and vests of restricted shares to employees need reporting to HMRC and similarly, awards to and exercises by employees of options also need to be included on the report. Employers need to indicate whether any tax elections have been made and also whether any apportionments have been applied in relation to internationally mobile employees.
- Employers may need to report either Carried Interest or Co-investment partnership interests awarded to employees on the HMRC annual report for Employment Related Securities ('ERS').
- It can be difficult to report awards correctly because the HMRC online form was designed for awards of restricted shares and share options and not reporting partnership interests.
- Getting this report right is really important particularly if employees are being awarded carried interest or co-investment.
- Increasingly HMRC are using these reports to test compliance with the detailed tax rules that can apply to carried interest and co-investment.
- We are seeing increasing scrutiny from HMRC into how employers value and treat these types of awards for the purposes of employment taxes.

What do I need to report to HMRC?

- The award of an interest in a carried interest partnership to an employee or office holder is often regarded as an ERS and is a reportable event. A co-investment partnership interest could also be a reportable ERS.
- New carry and co-invest scheme may need to be registered with HMRC.
- It does not matter that the employee may have paid the fair market value for those interests. Even when the individual pays the fair market value of the ERS they may still need to be reported.

Should we report awards that we believe are in the MOU?

- Yes. Awards of carry that are within the Memorandum of Understanding ('MOU') are still ERS and therefore need to be reported.
- Your reporting needs to be consistent with your house view on your awards. Consistency is important in any situation where an employer needs to explain the reason for their treatment to HMRC.

Reporting of carry and co-invest - 'Form 42' (continued)

Is it difficult to complete this report?

- It can be complex because the questions contained in the online report and the HMRC guidance notes are designed for awards of restricted shares and share options.
- Answering the questions literally can result in some misleading answers and therefore employers need an approach which is consistent and reflects the commercial reality of what is being awarded.
- HMRC software will reject a report which is not formatted correctly (it can be as minor as leaving a cell blank).

What about awards of carry to partners?

- Only awards of employment related securities to employees (including 'salaried members') or office holders (e.g. company Directors) need to be reported.
- However, it can be difficult to determine who is an office holder given that Alternative Investment Fund Managers can often hold a number of roles within the organisation which may include Directorships. Employers should establish whether the holding of these offices require their carried interest and co-investment interests to be reported.

Why is it important to get the reporting right?

- HMRC use these on-line reports as part of testing the complex tax rules that govern carried interest and the associated employer compliance.
- Certain entries will flag areas for further investigation such as the online entries not matching up with the payroll treatment.
- There are also financial penalties for incorrect annual returns including a fine of up to £5,000 for an incorrect return.

Next steps

- Consider whether you need to register a scheme and make an ERS report
- Analysis on which awards have been made to employees, individuals taxed as employees and officeholders and therefore need to be reported.
- Gather data on what awards have been made in the period 6 April 2021 to 5 April 2022 and the key data needed to report

Aggie Malarz
Senior Manager
M: +44 (0)7525 926348
E: agnieszka.malarz@pwc.com

Matthew Wright
Director
M: +44 (0)7738 310483
E: matthew.g.wright@pwc.com

Deal Contingent Forwards - Disregard Regs

Background

Deal Contingent Forwards ("DCFs") are generally the preferred instrument for hedging economic exposure arising from differences in the funding currency, and the acquisition currency of a transaction where there is some uncertainty on whether completion will happen (e.g. due to regulatory or competition approvals). However, under the previous Disregard Regulations (SI 2004/3256), there was no provision for mitigating foreign exchange ("FX") gains and losses arising in respect of a DCF. This was because a DCF could not fall within the existing rules for hedging shares, as typically the asset being hedged was yet to be acquired. Instead a DCF is used to hedge a forecast transaction/firm commitment to acquire a Target. Therefore alternative structuring has previously been required to tax hedge the FX exposure.

New disregard rules (the "new regs") have come into force from 1 April 2022 (Reg 5ZA), to include DCFs within the Disregard Regulations, such that profits or losses arising on DCFs can now be disregarded for UK corporation tax purposes. In certain scenarios, this will simplify the structuring required in order to hedge FX exposure on DCFs.

Overview of rules

There are three situations (or relevant hedging relationships) in which the new regs will apply to hedge FX exposure on a DCF (or, less commonly, a vanilla FX option/future). The contract (or part of the contract) must be intended to hedge the economic risk to the company in relation to:

1. The anticipated acquisition cost, together with any incidental costs of the acquisition, of the anticipated transaction,
2. The disposal proceeds of, and any relevant dividend in relation to the relevant shareholding paid as part of, the anticipated transaction, or
3. The subscription of shares in, or entering into a creditor relationship with, another company for the purpose of financing the anticipated acquisition cost, together with any incidental costs of the acquisition, of the anticipated transaction (subject to certain conditions).

Moreover, the economic risk must be attributable to FX exposure arising from differences in i) the currency of the forecast transaction (or firm commitment), and ii) the company's relevant currency, or the currency in which it will be financing the transaction.

Broadly, the first two situations deal with external cashflows on which FX gains and losses may arise. The third situation generally deals with an internal cashflows into BidCo.

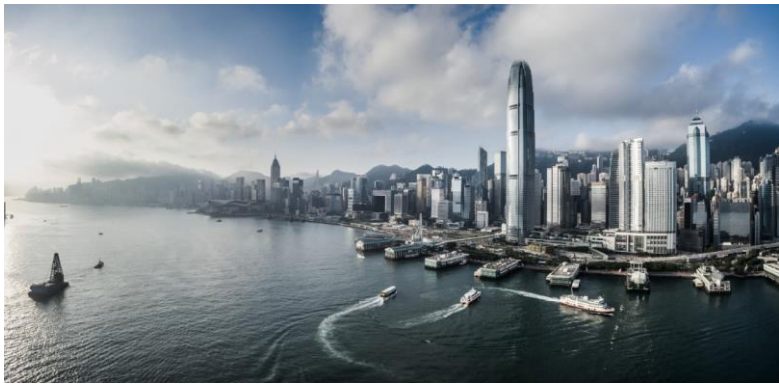
Under the new regs, the derivative must be held at the level of the transaction being hedged, therefore if a derivative is entered into higher up the structure, the new regs would not apply unless there was a back-to-back derivative entered into within the group, which mirrors the external cashflow.

Inconsistencies under the new regs

Which FX movements are disregarded?

Under the new regs, all profits and losses arising in respect of FX exposure on a DCF can be disregarded, however, where the hedging instrument is a vanilla FX forward, then only spot to FX movements are disregarded (so the interest differential/forward points are still deductible or taxable).

Given the additional cost of a DCF or an option over a vanilla FX forward this difference in approach to disregarding some or all of the profits or losses may be significant and is difficult to rationalize from a policy perspective. HMRC have declined to adopt a consistent approach here.



Deal Contingent Forwards - Disregard Regs (continued)

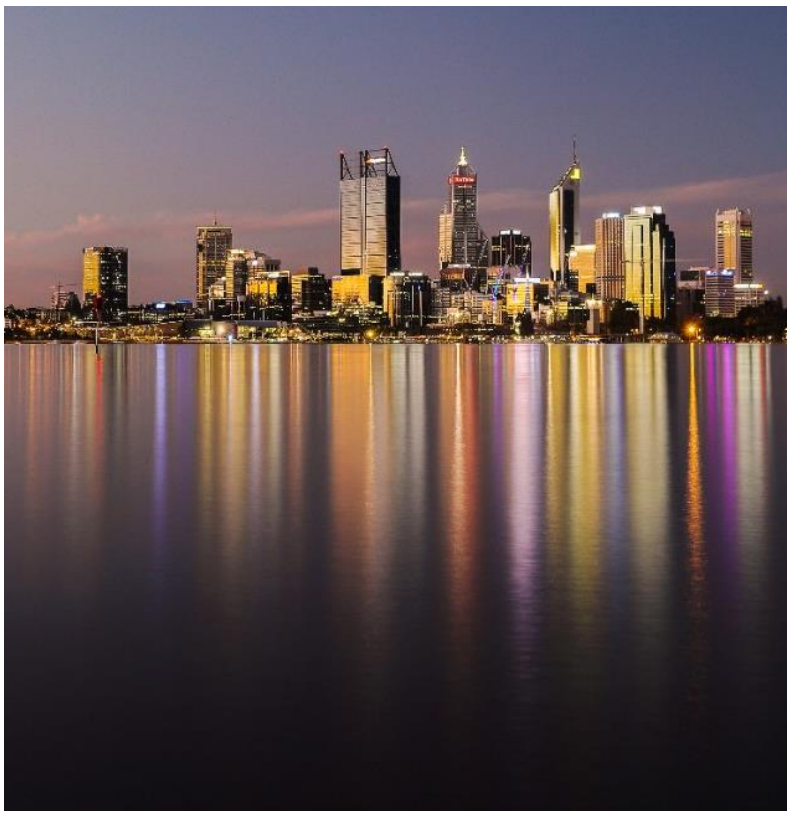
Relevant shareholding vs. Substantial shareholding

The new regs are also inconsistent in respect of what types of shareholding they apply to. Under situations 1 and 2 as set out above (i.e. FX exposure on external cashflows), the new regs refer to a "*relevant shareholding*", defined as:

1. A shareholding in another company which is, at the date the derivative contract is entered into, a substantial shareholding (see below), and
2. Where the company entering into the relevant hedging relationships a qualifying asset holding company ("QAHC"), a holding of qualifying shares.

By contrast, under situation 3 as set out above (i.e. FX exposure on internal cashflows), the new regs refer to a "*substantial shareholding*" (broadly where a company *directly or indirectly* holds 10% of the shares in another company).

This means that under situation 3 (i.e. FX exposure on internal cashflows), the scope of application is more limited than under situations 1 and 2 (i.e. FX exposure on external cashflows).



Next steps

- The new regs are a welcome development, in that the additional structuring requirements to hedge foreign exchange arising on a DCF for tax purposes should no longer be required in most circumstances. However, there are limitations in how the rules are currently drafted, particularly in light of Pillar 2.
- Under Pillar 2 the effective tax rate must be calculated per jurisdiction, and top-up tax must be paid for the difference between the effective tax rate per jurisdiction, and the 15% minimum rate.
- Under the new regs, profits and losses arising on the DCF are disregarded. If the DCF stands at a profit, this will reduce the effective tax rate (as that profit will not be taxable), which means that potentially a top-up tax could be required if the group meets the requirements for Pillar 2 to apply. Therefore, once Pillar 2 is in force, and if a group is expected to meet the requirements for Pillar 2 to apply, an alternative approach will be needed that does not create a potential Pillar 2 adjustment. This means that for some groups, the new regs will have a limited shelf-life.

Graham J Williams
Director
M: +44 (0)7889 644815
E: graham.j.williams@pwc.com

Kirsten Goodridge
Manager
M: +44 (0)7483 941745
E: kirsten.goodridge@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

Tim Hill
Partner
M: +44 (0) 7734 958732
E: tim.hill@pwc.com

Editorial team

Philipp Naumov
Senior Associate
M: +44 (0) 7526 559976
E: filipp.naumov@pwc.com

200206-154355-ML-OS