# Keeping up with Alternative Investment Funds

July 2022

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# Introduction

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

The big news this month is the anticipated legislative developments announced as a part of 'L-day' on 20 July, as well as the First Tier Tribunal's decision on the BlueCrest case on Salaried Member rules in the context of investment management.

In our News Bulletin section we review the key L-day proposals, including UK Pillar 2 legislation, an update to QAHC rules, R&D relief and transfer pricing, as well as an overview of the BlueCrest decision.

Our July newsletter also looks at a wide range of topics in depth: we have analysed the UK Digital Assets consultations and announcements, including expansion of the IME to include cryptoassets and development of the rules surrounding decentralised finance staking and lending, as well as the impact of the changes to the US foreign tax credit brought by the 2021 Regulations on AIF industry.

In this edition we also have considered the impact of the new double tax treaty signed by the UK and Luxembourg earlier this month.

See the full list of articles in this newsletter below:

- UK Digital Assets consultations and announcements – update for Alternative Asset Managers
- US Foreign Tax Credit Regulations and the New Limitations Potential Impact for AIFs
- Achieving Scale – moving the operating model from artisan to industrial
- The new UK-Luxembourg double tax treaty and its impact on UK real estate holdings
- UK Economic Crime Act deadlines
- Hungarian financial transaction tax on cross-border services

We will be taking a break for the month of August and will be returning in September with a special edition of Keeping up with Alternative Investment Funds focused on UK Fund and Platform structures.

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,

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# News Bulletin

## Legislation day

In line with the tax policy-making framework, the Government has published draft legislation to be included in Finance Bill 2022-23. This allows for technical consultation and provides taxpayers with predictability over future tax policy changes. Alongside this, the Government is making announcements in a number of areas of tax policy. The key areas include:

- **R&D tax relief reforms:** The **draft legislation** amends the definition of qualifying expenditure to include data, mathematical applications and cloud costs (ensuring the reliefs support modern innovation). These changes should expand the availability of R&D for asset managers. The draft legislation also refocuses the reliefs towards R&D in the UK and implements measures to improve compliance. The Government will limit overseas spending on subcontracted R&D and externally provided workers, with some limited exceptions.
- **Transfer pricing documentation:** The **draft legislation** includes a requirement for large multinational businesses operating in the UK to keep and retain transfer pricing documentation in a prescribed and standardised format, set out in the OECD's Transfer Pricing Guidelines (Master File/Local File). It also introduces the requirement to complete a Summary Audit Trail (SAT), which will detail the main actions the taxpayer has taken in preparing their UK local file documentation.
- **Qualifying Asset Holding Companies regime:** HMRC has published the **draft legislation** providing welcome amendments to accommodate parallel funds in the regime and to facilitate entry into the regime of certain types of fund entity that would be a collective investment scheme if they did not have characteristics of a body corporate, as well as introducing a new anti-avoidance provision by extending the anti-fragmentation rule, in line with the original scope of the regime. We will be reviewing the draft legislation and will provide our feedback during the working group sessions with HMRC and HMT in due course.

## Draft UK Pillar 2 legislation released

**Draft UK legislation** has now been released to introduce the OECD's Pillar 2 model rules into UK law as part of Finance Bill 2022/23. The Income Inclusion Rules (IIR) apply to accounting periods commencing on or after 31 December 2023. The government also intends to introduce an Undertaxed Payment Rule (UTPR) in the UK and will make a final decision on timing at a later date.

With regards to the introduction of a UK Domestic Minimum Tax (DMT) the government maintains the belief that there are strong arguments in favour of a UK DMT to ensure the UK Exchequer receives any additional tax arising from Pillar 2 on UK economic activities. The government will continue to consider the introduction of a DMT and envisages that, if introduced: the threshold would be €750m to mirror the Pillar 2 rules; and it would apply to both UK-headed and foreign-headed groups. It will also consider the costs and merits of applying it to wholly domestic groups to prevent economic distortions.

The overall approach to the drafting of the legislation has been to closely follow the intent of the Model Rules but to adapt the structure and drafting in places in an attempt to ensure that the rules are as clear to users as possible. Whilst additional certainty has been provided in the draft legislation there are several issues that the government believe should be addressed within the context of Administrative Guidance as part of the Implementation Framework (IF) at the OECD level. Examples of issues to be discussed further as part of the IF are: the transitional provisions relating to intra group asset transfers; exclusions for foreign exchange gains and losses on hedging instruments; addressing situations where a top of tax can arise in a loss making period and exclusions for credits from certain debt releases.

Addressing these issues at an international level will ensure that consistency is maintained across implementing jurisdictions and minimise the risks of disputes and uncertainty. The government does subsequently note that it will remain open to resolving some issues domestically where it is necessary to avoid disproportionate and unintended outcomes, provided that this does not challenge the common approach or produce risks to the Exchequer or risks of double taxation to business.

# News Bulletin (continued)

The government has invited feedback on both the draft legislation and their response to the previous UK consultation on the UK implementation of Pillar 2. They also welcome continued engagement with stakeholders. The consultation will last until 14 September 2022 to inform the final drafting of the legislation. We are working through the draft UK rules in detail and will share further specific insights with you in due course.

Notwithstanding that further changes may be made to the UK Pillar 2 rules, based on experience of working with other groups, we think you would be best served by undertaking an impact assessment now, preparing a roadmap to be Pillar 2 ready and engaging with the relevant stakeholders in your organisation to get their buy in and support for any necessary resources. We have summarised some of the key issues in getting Pillar 2 ready below along with reasons why we think that it is beneficial to start this sooner rather than later.

In addition, it is worth noting that the draft legislation (in line with the Model Rules) contains transitional rules which apply to transactions undertaken now and can impact the Pillar 2 position for the Group once the rules are in place (from 2024 onwards). It is therefore important that the draft legislation is factored into the consideration of any current transactions.

## UK sovereign immunity consultation

On 4 July, the UK Government launched a public consultation to update its sovereign immunity regime.

The consultation is open for comments until 12 September and the Government is open to meeting with stakeholders and interested parties during this consultation period. These meetings should be requested before 25 July.

The main headline from the consultation is that the Government is seeking to expand the tax base for sovereign immune entities by bringing income and gains from UK immovable property into tax.

In summary:

- The Government is proposing to set out the sovereign regime in legislation, and to provide sovereign immunity from direct taxation only for withholding tax on UK-sourced interest income not related to trading activities in the UK.
- If the proposed changes are adopted, they would be particularly relevant for UK non-resident capital gains tax ('NRCGT') arising on UK real estate-rich investments (subject to the various NRCGT requirements under the 'general regime').
- Sovereign investors can currently benefit from certain relaxations to the Substantial Shareholding Exemption ('SSE') on disposals of shares under the Qualifying Institutional Investor ('QII') provisions, including a waiver of the trading requirement under certain thresholds of sovereign ownership. The consultation also proposes potential changes to the QII provisions to align with the objectives of sovereign immunity reform.
- The Government proposes the new rules would apply from 1 April 2024, with transitional rules to ensure that capital gains accrued before the new rules come into effect are not caught.
- The consultation document expressly states that sovereign immunity reform should not impact the status of sovereigns as qualifying investors for the new UK Qualifying Asset Holding Company regime.

PwC will be meeting with HMT/HMRC on 2 August and will be providing its own comments on the consultations shortly before the September deadline.

We would be happy to share further thoughts and to support if you would like to discuss/provide input our consultation response.

# News Bulletin (continued)

## No corporate prosecutions for tax evasion under Criminal Finances Act

HMRC has not prosecuted any companies under corporate tax evasion powers introduced five years ago, while the number of live investigations has fallen to just seven. The corporate criminal offence for companies failing to prevent those associated with the business from facilitating tax evasion came into force in September 2017 under the Criminal Finances Act. There were seven live investigations as of May this year, according to HMRC figures. A further 21 live opportunities for investigation were under review and it had reviewed and rejected an additional 69 opportunities. A spokeswoman for HMRC said: 'Corporate criminal offences were introduced to encourage organisations to put preventative measures in place to reduce tax evasion. The success of the new offences can already be seen in a corporate culture shift towards anti-tax evasion awareness and procedures'.

## US Inflation Reduction Act of 2022

Senate Majority Leader Schumer and Senator Manchin announced a deal on a new version of the Build Back Better / tax reconciliation bill called the Inflation Reduction Act of 2022.

The bill includes amendments to the existing carried interest rules, as well as 15% corporate minimum tax. While the summary does not further explain the carried interest in detail, we understand that it is proposed to increase the holding period required to treat a gain allocated to a carried interest as long-term capital gain from three to five years. We will share the update as soon as Schumer and Manchin provide additional details.

# News Bulletin - the BlueCrest decision

On 29 June 2022, the First-tier Tribunal has released its first decision that considered application of the Salaried Members legislation and addresses a number of arguments that are currently being raised by HMRC across the asset management sector.

## Background

The salaried members rules at s863A-G ITTOIA 2005 (and the equivalent NICs provisions) aim to tackle situations where individuals who would otherwise be employees are members in LLPs in order to avoid PAYE and NICs liabilities. If the rules apply, a member of an LLP is deemed to be an employee for employment tax purposes and the LLP is assessed to PAYE and NICs accordingly.

The salaried members rules will apply in circumstances where an individual satisfies three Conditions (A, B and C). If an individual fails one of these conditions then the rules will not apply. The conditions broadly test:

Condition A - whether the individual receives a share of the partnership profits or something more akin to a salary (or bonus).

Condition B - whether the individual has a level of control over the affairs of the partnership that would be expected of a partner.

Condition C - whether the individual, personally, has capital at stake in the business.

The decision in Bluecrest focuses on the application of Conditions A and B.

## Condition A

In assessing whether at least 80% of the individual's remuneration was disguised salary (i.e. that it was either fixed or variable but not by reference to the profits of the partnership) so that the individual would be inside the salaried members rules:

- There is no need for an individual's remuneration to directly track the overall profits and losses of the partnership (i.e. a member's profits do not necessarily have to increase if the profits of the partnership increase).
- Condition A can still be failed in circumstances where the overall profits of the partnership fall but the individual receives a larger share of those profits.
- However, the taxpayer has to show a direct link between the individual's remuneration and the accounting profits of the partnership.

This link cannot simply be that where there are fewer profits available for distribution the individual will receive a lesser amount.

In Bluecrest it was found that whilst the individual partner's remuneration varied, it varied by reference to their own personal performance. The relevant allocation mechanism did not evidence the required link to show that the portfolio managers were in fact entitled to share in a proportion of the overall profits. The Tribunal noted that if the partnership were to do better than expected, the partners would not share in the uplift by virtue of the fact that "income points" are heavily weighted in favor of corporate members. Further, there was no evidence that the relevant board had considered the overall profit of the partnership when making individual discretionary allocations.

## Application of the TAAR

The Tribunal also (briefly) considered the application of the TAAR which allows the Tribunal to disregard arrangements which have been put in place for the purpose (or main purpose) of securing that a member is not taxed as an employee. This was considered in the context of a resolution that was put in place to ensure that the profits determined to be distributed in a given year by management should not exceed the total profits of the LLP and should be reduced accordingly on the basis that the total amount of profit was exceeded. The Tribunal found that this resolution was put in place purely for the purposes of ensuring potential variability under the salaried member rules as it simply put beyond doubt something that was (on the Tribunal's analysis) already a given (that a partnership cannot allocate more profits than its has available).

# News Bulletin - the BlueCrest decision

## Condition B

In assessing whether the individual portfolio managers had significant influence over the affairs of the partnership:

- The assessment of influence can include direct financial influence (this is not simply an assessment of managerial influence).
- Significant influence can be over aspects of the affairs of the partnership and not the affairs of the partnership as a whole.
- The starting point for the analysis is to identify what the business of the partnership is and consequently what the partners do.
- Making a comparison to a "traditional" partnership, condition B looks at the ongoing contribution of the individual from an operational perspective. The role of the traditional partner is to "find, mind and grind", noting that some partners are better at getting the work and others are better at doing it.
- As a consequence, influence is not limited to management decisions but other actions contributing to the success of the partnership (including local management of work done).

In Bluecrest, the Tribunal found that the partnership's activities were to provide investment advice to the general partner and also to provide back office functions for other members of the group. Provided that it can be shown that the individual member influences either the investment activities or the provision of back office services then the member will fail condition B.

Importantly, the Tribunal rejected an HMRC argument that the partnership should be treated as some form of captive which operates at the behest of the broader group (provided that the individual members had the essential competencies to make operational decisions). Portfolio managers were found to exercise their influence by virtue of the investment decisions that they made (and the consequential financial impact that had on the LLP's business) in respect of the capital that had been allocated to them to manage.

In relation to non-portfolio managers carrying out functions related to HR, finance, tax etc. the Tribunal again compared these roles to those of partners in a traditional partnership and found that these were roles which could be undertaken by specialist employees.

However, the Tribunal also noted that those members who provided back-office services on behalf of Bluecrest and had significant influence over the provision of those services could fail condition B (especially where those services generated significant income for the partnership); however, there was insufficient evidence presented to determine the influence of the relevant individual members in respect of the provision of these services.

## Conclusions

Whilst the Tribunal's comments around Condition B are extremely helpful and support the analysis that many taxpayers have been putting forward to HMRC for a number of years, we anticipate that these arguments will be appealed to the Upper Tribunal.

The decision on middle and back office LLP members demonstrates the need to document and evidence how someone's role is significant in the context of the actual business of the LLP in order to fail Condition B.

The Tribunal's judgment on Condition A is more difficult. The fact that the Tribunal has grounded its conclusions in the (lack of) evidence, as opposed to making statements of principle, makes it very difficult to challenge these conclusions on appeal. Given that the Tribunal at least appears to have rejected an "eat what you kill" model of partner remuneration, careful thought will need to be given by taxpayers to finding objective evidence that can be presented to HMRC / a Tribunal demonstrating a more definite link between the sum a partner receives and the actual accounting profits of the LLP.

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# UK Digital Assets consultations and announcements – update for Alternative Asset Managers

There have been a number of announcements in the last few months from the Government as they continue to pursue their strategy of seeking to establish clear UK tax and regulatory treatment of crypto assets to place the UK at the forefront of safe, sustainable and rapid innovation in crypto asset and blockchain technologies.

One of those measures is to expand the investment management exemption ("IME") to include types of crypto assets. This will provide certainty of tax treatment to UK investment managers and their non-UK resident investors who are seeking to include crypto assets within their portfolios, and it is anticipated that this will also encourage new crypto asset investment management businesses to be based in the UK.

The government is also seeking views on the taxation of crypto asset loans and 'staking' within the context of Decentralised Finance ("DeFi"). In particular, the government is interested in ascertaining whether administrative burdens and costs could be reduced for taxpayers engaging in this activity, and whether the tax treatment can be better aligned with the underlying economics of the transactions involved.

## Expanding the Investment Transactions List for the Investment Management Exemption and other fund tax regimes

### *Background*

The IME exists to provide a safe harbour for trading funds and their investors so that there is certainty that appointing a UK investment manager to undertake investment transactions on their behalf will not lead to those transactions falling within the scope of UK taxation. The concern otherwise would be that the Investment Manager is seen as a dependent agent of the fund and therefore could create a permanent establishment of the fund in the UK through its activities.

As well as meeting the conditions of the IME, it is also important that the transactions entered into by the UK Investment Manager are "investment transactions". What is an "investment transaction" is set out in The Investment Transactions (Tax) Regulations 2014 often referred to as the "Investment Transactions List" or "ITL". Whilst this ITL covers many traditional assets and instruments, it has been unclear whether transactions in crypto assets have fallen within the list. As an example, HMRC have publicly stated that they do not believe crypto assets to be considered "currencies' ' and the analysis as to whether a crypto asset may be treated as a "security" is often complex.

Often UK managers have therefore accessed crypto asset exposure synthetically via derivatives or indirectly by transacting in other assets and products (such as shares/units in Exchange Traded Funds ("ETFs)") in order to try and ensure that these transactions remain within the ITL.

It should also be noted that the ITL is used by other UK fund regimes.

### *Government and HMRC proposals, focus and requests*

It is clear from the consultation that the main focus is defining crypto assets for the purposes of the investment transactions list rather than assessing the concept of adding them. The existing definitions used by HM Treasury, HMRC, the Financial Conduct Authority ("FCA") and the Bank of England are generally helpful for the industry as a whole, albeit given there are in excess of 20,000 digital assets and that number is increasing, it is a constant challenge to maintain a consistent and effective taxonomy.

It is important that the definition limits crypto assets to those that can be used as investment products by asset managers. It will also be limited so as to ensure crypto assts cannot be used to circumvent other exclusions from the investment transaction list, such as transactions in land and transfers of intangible value and also to exclude 'closed-loop crypto assets'. The consultation also seeks to obtain information on what types of crypto assets managers would seek to include in their portfolios and other industry data. The consultation closed on 18 July 2022 and we await further information.

### *The 4th Annual Global Crypto Hedge Fund Report*

**The 4th Annual Global Crypto Hedge Fund Report** ('the Report') evidences why it's important that the government and HMRC seek to address these issues and update the Investment Transactions List.

According to the report, the UK is the second top Crypto Hedge Fund Manager location (for Crypto specific hedge funds) and given that one in three "traditional" hedge funds (surveyed) are currently investing in digital assets (and many of these will have a UK presence given the size of the UK industry), there may be significant opportunity to provide tax certainty and attract further growth.

# UK Digital Assets consultations and announcements – update for Alternative Asset Managers (continued)

The Report also includes some useful insight into current focuses of these managers, asset preference and their product types.

Exchange tokens and stablecoins remain the most popular digital asset. Specifically the mainstream cryptocurrencies such as Bitcoin ("BTC") and Ethereum ("ETH") remain the most popular target asset of most multi asset managers. In the Report, the majority responded that they are invested in BTC and ETH, with 67% each respectively. However, exposure to altcoins is increasing.

More broadly, approximately one in three of all respondents (29%) say that they are invested in other tokens listed on centralised exchanges, one in four (24%) say that they are invested in tokens listed on decentralised exchanges, while one in five respondents (19%) say that they are invested in NFTs. Assuming HMRC wants to make changes to the investment transactions list to effectively include a wide range of cryptoassets, perhaps they could include these categories of asset in the definition given they are clearly sought after as investment products.

In terms of obtaining exposure to these assets, derivative trading, including options and futures, appears to remain the most typical way of accessing exposure to digital assets. Exposure is also obtained in other ways via direct/spot trading, Exchange Traded Products, actively managed products and venture capital products. As the market remains reasonably new, asset access and servicing is improving and so it will be helpful to the UK industry to be able to secure exposure in many different ways and to have certainty under the investment transactions list rather than being limited to derivatives for example.

## The taxation of Decentralised Finance involving the lending and staking of crypto assets

*Background*

Generally, staking is a way of earning passive income on crypto assets and refers to the lending or contribution of tokens to a blockchain in order to maintain it and receive a share of the rewards for doing so. Staking transactions may be locked in a "smart contract" on a decentralized finance (DeFi) application.

Unfortunately, due to the current tax rules in the UK, there are situations where such transactions are treated as disposals despite the fact that the effective economic ownership of crypto assets is retained. Very broadly this is because the process for "staking" of a crypto asset may lead to it being considered to be an initial disposal of an asset and then the acquisition of a new asset rather than a true "lending" of the original asset. Not only can this lead to a tax charge but it is administratively difficult to track all staking activity, especially if there are many deemed disposals.

# UK Digital Assets consultations and announcements – update for Alternative Asset Managers (continued)

## *HMRC proposals, focus and requests*

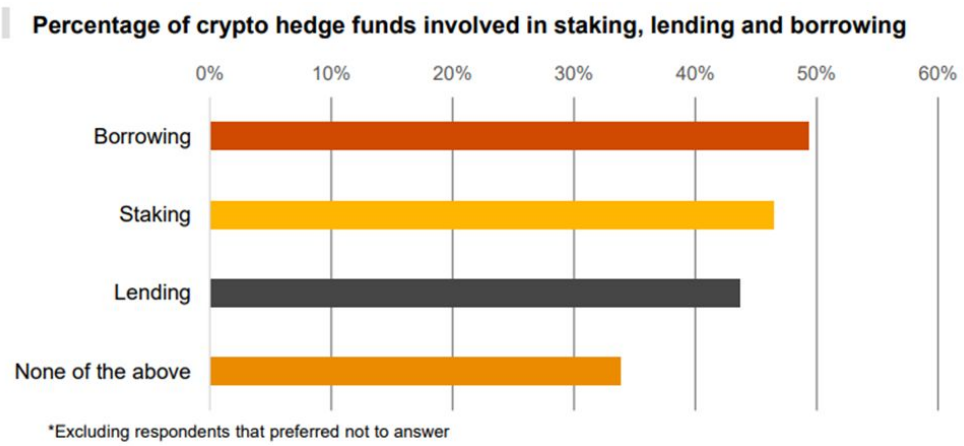
HMRC acknowledge this issue and is reviewing the current tax treatment of DeFi lending and staking in the light of the objectives and principles set out below.

- Tax neutrality between economically equivalent activities
- The tax system ought to reflect the economic substance of the activity in question
- An efficient tax system that is perceived as fair and predictable
- Minimising the administrative burden required to comply with tax rules

There is precedent for rules in this regard, i.e. where there are transfers of securities but without a disposal of the economic rights or beneficial ownership, most notably the UK repo and stock lending regimes.

HMRC have called for evidence and are considering whether to incorporate DeFi staking and lending into these existing rules, establishing a standalone set of similar rules or creating a 'no gain no loss' rule for these transactions and have asked for views in this respect. The **call for evidence** closes on 31 August 2022.

Turning again to the Report, the table below shows the prevalence of staking amongst Crypto Hedge Funds and depending on the structure of the funds, the holdings and the staking mechanism and the investors, it is likely that further clarity here would be beneficial to reduce tax risk and administration. Of course, the overall tax profile of the above would need to be assessed.




**Next steps and the Financial Services and Markets Bill**

Just last week the The Financial Services and Markets Bill was introduced to Parliament. To ensure the UK remains at the forefront of new technologies and innovations, the Bill will enable certain types of stablecoins to be regulated as a form of payment in the UK. In fostering these new innovations, the Bill will also enable the creation of Financial Markets Infrastructure Sandboxes – allowing firms to test the use of new technologies and practices in financial markets, increasing efficiency, transparency and resilience of new products.

The government appears committed to expanding the UK's current regulatory, tax and legal frameworks to make the UK more attractive to digital asset and DeFi businesses and so it will be important to continue to monitor developments which are expected to be reasonably frequent.

However, as of today uncertainty does remain in many areas so it is crucial that potential positive views of the future do not cloud the need to ascertain the correct tax treatment and ensure compliance today.

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# UK Digital Assets consultations and announcements – update for Alternative Asset Managers (continued)

## UK regulation

The UK is set to introduce new regulation that will affect crypto markets. Cryptocurrency providers and traders will be impacted by these reforms and should consider how to adapt to meet upcoming requirements and evolving regulatory expectations.

The widespread use of cryptocurrency in the UK is growing rapidly. Recent volatility of cryptocurrency prices (with Bitcoin grabbing the headlines) and subsequent market failures underscore the risks of the crypto markets being left unchecked. It is therefore no surprise to see the UK looking to bridge that gap with a number of initiatives. The UK regulator, Financial Conduct Authority (the "FCA"), and UK Government are developing new rules and playing catch-up as the UK is aiming to become, in the words of John Glen MP, the Economic Secretary to the Treasury and City Minister, "an attractive hub for all things digital and for new technologies more generally".

## Upcoming UK regulations

In the cacophony of changes, we have identified two groups of reforms that are particularly important for cryptocurrencies:

*Marketing by cryptocurrency platforms:* In addition to crypto assets that are already captured by the existing regulatory perimeter (such as security tokens or e-money tokens), HM Treasury is looking to bring in scope of UK regulation other more commonly used crypto assets such as Bitcoin, though non-fungible tokens (or NFTs) are expected to remain largely unregulated. This would mean that any marketing by cryptocurrency platforms of trading of in-scope crypto assets will need to be approved by an authorised person (or to fall in scope of an available exemption).

HM Treasury and the FCA are also considering strengthening the financial promotions rules by (among others):

- narrowing the exemptions for high net worth individuals and sophisticated investors;
- introducing a new gateway for authorised firms approving financial promotions for unauthorised persons (e.g. cryptocurrency platforms);
- introducing more robust rules for approving financial promotions (e.g. including an approval datestamp as well as competency, due diligence and on-going monitoring requirements for approvers); and
- strengthening customer journey requirements for authorised firms (e.g. through significantly limiting direct offer financial promotions of certain mass market investments, which will in due course include qualifying crypto assets, to retail customers).

*Stablecoins as means of payment:* Following industry consultation, HM Treasury intends to bring certain stablecoins (i.e. cryptocurrency based on a single or multiple fiat currencies) that are used as a means of payment into the UK regulatory perimeter by amending existing electronic money and payments legislation (which in itself is expected to be reformed as part of the Future Regulatory Framework and evolve from prescriptive and inflexible legislation into an FCA-driven framework). This will in effect require stablecoin issuers, stablecoin custodial wallet providers and stablecoin exchanges to become FCA authorised.

In addition, the UK Government is planning to regulate systemically important stablecoin-based payment systems and is considering how regulation should deal with the failure of systemic stablecoins and their operators. The proposals do not seem to address the relationship between the proposed new regimes and banks who wish to issue their own stablecoins. Further consultations are expected in relation to tokenisation of assets and use of distributed ledger technology ("DLT") in financial market infrastructure ("FMI"), including the FCA developing a sandbox for testing DLT solutions for FMIs.

**Next steps**

It is clear that regulation of cryptocurrencies in the UK is quickly expanding. As a result, crypto firms need to assess the impact of the upcoming regulation against their business models to identify any regulatory touch points, such as:

- the need to become FCA authorised (e.g. if involved in issuing, trading or custody of stablecoins);
- using an appropriately authorised firm as approver of marketing materials and financial promotions in the UK; and
- the ability to offer products and/or services to consumers in the UK.

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# US Foreign Tax Credit Regulations and the New Limitations Potential Impact for AIFs

On December 28, 2021, the Internal Revenue Service released final regulations addressing multiple aspects of the foreign tax credit ('FTC') regime (the '2021 Final Regulations'). The 2021 Final Regulations finalize a number of provisions previously set forth in proposed FTC regulations that were released on September 29, 2020 (the '2020 Proposed Regulations').

While the 2021 Final Regulations retain the general framework of the final regulations addressing when a foreign tax will be treated as creditable under section 901, there are some significant changes that may impact the creditability of foreign taxes paid or accrued in taxable years post December 2021. This is expected to have an impact on the AIF industry, specifically for any funds with U.S. investors.

## Summary of Potential Impact

As part of the 2021 Final Regulations, additional requirements are being imposed with respect to the ability for U.S. taxable investors to claim a tax credit in relation to taxes imposed by foreign jurisdictions upon a direct or indirect transfer of shares (e.g., China, India, Brazil non-resident capital gains tax) or certain non-U.S. withholding taxes. While a case-by-case analysis would need to be undertaken, in short, where the foreign taxes are not considered 'equivalent' to a tax that the U.S. would have imposed in a similar situation (i.e., the U.S. generally does not tax capital gains realized by non-residents upon a transfer of non-real estate shares), then such foreign taxes may no longer be creditable under U.S. tax law.

However, those foreign taxes might still be creditable under the provisions of tax treaties (e.g., with China or India) but likely need an analysis on a structure-by-structure basis. With respect to jurisdictions that do not have a tax treaty with the U.S., it may be the case that foreign tax credits could no longer be claimed (e.g., Brazil and certain other LATAM jurisdictions).

The 2021 Final Regulations apply to foreign taxes paid or accrued in taxable years beginning on or after December 28, 2021.

## Attribution Requirement

One of the material changes is the addition of an attribution requirement or 'jurisdictional nexus' which must be met in order for a foreign tax to be creditable.

The attribution requirement aims at determining whether the activity subject to tax has sufficient connection to the foreign country imposing the tax. Generally, a sufficient connection requires foreign tax rules to be reasonably similar to U.S. tax rules in order for a foreign levy to be a creditable tax within the meaning of sections 901 and 903.

The attribution requirement is now part of the net gain requirement and provides that taxes on nonresidents must satisfy one of three tests:

- An ‘activities-based attribution requirement’, where income subject to tax is attributable to a non-resident’s activities in the foreign country and not based on the location of customers;
- A ‘source-based attribution requirement’, where income is taxable because it arises from sources in the foreign country, and foreign sourcing rules must be ‘reasonably similar’ to the U.S. rules, or
- A ‘situs of property-based attribution requirement’, where income is taxable from the sale or disposition of property that is real property located in a foreign country or moveable property associated with a taxable presence.

Further, the 2021 Final Regulations narrow the definition of withholding taxes that are eligible for an FTC by imposing the new source-based attribution requirement described above that must be satisfied in order for a non-U.S. withholding tax to constitute a covered withholding tax.

In the absence of a specific statutory source rule in the Internal Revenue Code, a foreign law source rule satisfies the attribution requirement if it is reasonably similar to the U.S. source rule that applies by closest analogy. The predominant character of an income tax is no longer sufficient.

# US Foreign Tax Credit Regulations and the New Limitations Potential Impact for AIFs (continued)

As a result of this attribution requirement, for example, further consideration needs to be given to the creditability of non-resident capital gains tax (direct and indirect) imposed by a foreign country on the disposition of stock of non-real estate companies. However, it should be noted that the creditability of non-resident capital gains tax imposed by a foreign country on the disposition of stock of a real estate company could meet the attribution requirement under the U.S. FIRPTA rules.

## Treaty Interaction

The 2021 Final Regulations provide a treaty 'safe-harbor' rule that states a foreign levy that is treated as an income tax under the relief from double taxation article of a bilateral income tax treaty entered into by the United States and the foreign country imposing the tax may be a creditable foreign income tax if two conditions are met:

1. The relevant tax is covered under a US income tax treaty, and
2. The technical taxpayer claims the benefits of the treaty.

In other words, notwithstanding the above, if the tax is a covered tax under the relevant tax treaty and the technical taxpayer qualifies for treaty benefits and is claiming the benefits of the treaty (i.e., claims the credit under the treaty), the safe harbor is expected to apply; therefore, the tax is expected to be a creditable foreign tax.

Conversely, a tax imposed by a foreign jurisdiction that does not have a tax treaty with the U.S. may no longer be creditable unless the new criteria discussed above are met, and would need to be further considered – i.e., in these cases of noncreditability, query whether it would be advantageous to take a deduction as opposed to a credit for the foreign taxes paid.

**Next steps**

The Final 2021 Regulations are expected to have a significant impact on the creditability of foreign taxes, especially for those taxes imposed by jurisdictions which do not have tax treaties with the U.S. We are currently working with clients on analyses and assessments to determine the potential impact and assisting with providing documentation of position of creditability and/or treaty reliance. For a deeper discussion on how the Final 2021 Regulations may impact your organization, please reach out to the authors or your normal PwC contact.

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# Achieving scale – moving the operating model from artisan to industrial

## Context

The significant flow of assets in to alternatives has resulted in many of our clients having to re-evaluate how they operate. The simple processes and systems that enabled the early stages of growth are breaking at the seams and people are working 'burn out' hours to keep the show on the road. Moving from this artisanal model to something industrial that will stand the higher volumes, the test of increasingly sophisticated DD from investors and more focus from regulators is now the challenge.

## How did we get here?

As per the operating model maturity diagram (figure 1), we find that many firms start with a number of very capable 'do it all' type people who run the firm on a spreadsheet and then transition over time to some basic systems and processes. These firms are successful through sheer hard work and is reliant on the people that have been there from the start. They know where the process breaks and failures are and anticipate them, or know who to shout to across the office to keep the machine working.

Through our 'fit for growth' analysis we work with firms to look at the activities they are undertaking in each function and review the processes, technologies and sourcing set up. Through our quantitative analysis we typically find that functional areas are working at 130-175% of normalised capacity levels to cope with the workload. There are particular spikes in areas such as Finance around reporting points as well as operational spikes at fund raises. Legal and Tax are often at the higher end of these capacity levels as they struggle to build leverage into the teams.

Underlying the simple volume challenges is an operating model that has evolved with limited thought to the need for connected and technology driven processes. This is further worsened by service problems at the fund administrators. The support here can be highly variable and dependent on the team that is assigned to the manager, but the administrators are suffering similar problems with the exponential growth in the industry, poor underlying technologies and the bespoke and complex nature of many of the processes.

Ultimately we end up seeing the following issues as organisations grow:

- High levels of manual processes
- Non standardised and inconsistent processes
- Proliferation of spreadsheets
- Workflows based on email and MS Office products
- Lack of clean data
- Inability to rapidly respond to investor or deal team queries
- Replication of work done at the fund administrators due to errors
- Core functional systems that don't talk to each other and don't reconcile
- High levels of workload across core functions
- Dependencies on staff who have been there for some time and are often reliant on the more senior/experienced levels to do the work.

## How do we move to the next level?

Moving to an industrialised operating model is counter cultural to many evolving firms who have built their organisation on talented and versatile people who like to solve problems. The next stage of maturity seems rigid in that it requires people that like process, standardisation and control. It also requires proper programmatic change rather than just some people doing it off the side of the desk.

Depending on the maturity of the firm, we see the following areas of focus:

### *People and Process*

- Implementation of workflow – standardising areas such as the deal close process, client onboarding, fund set up, contract management
- Documentation of process and setting out roles and responsibilities
- Functionalisation with increasing specialisation of areas and moving away from strategy alignment

# Achieving scale – moving the operating model from artisan to industrial (continued)

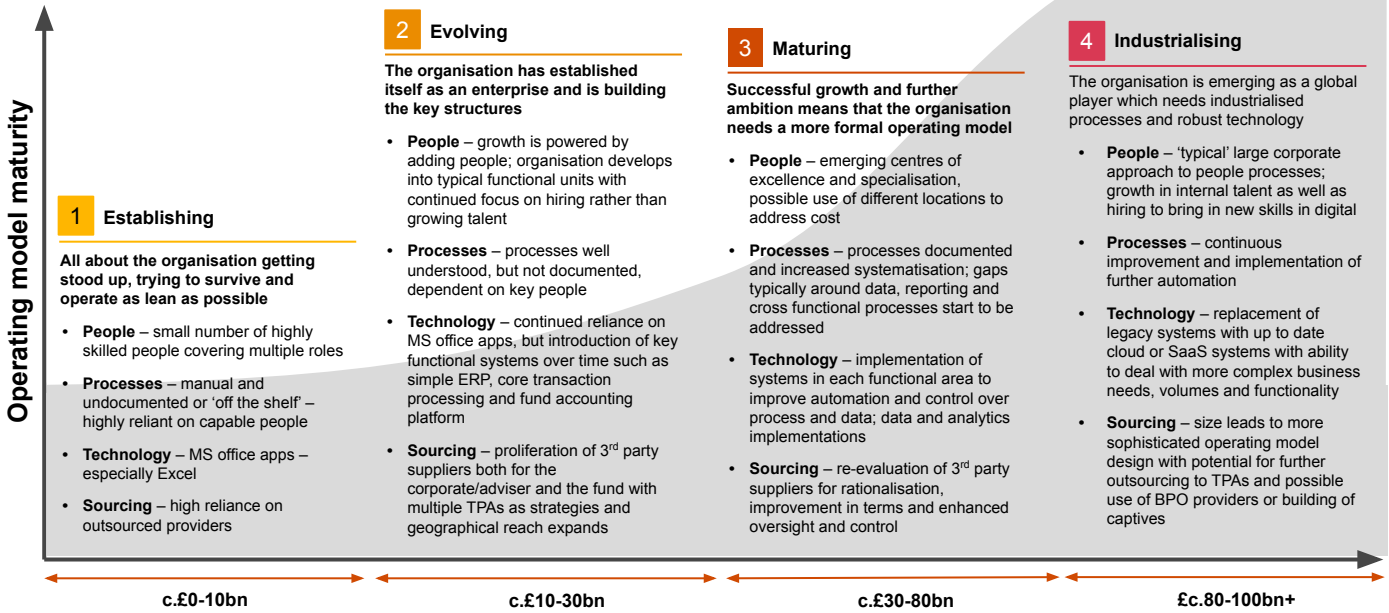
## *Sourcing*

- Developing service standards and SLAs with KPIs and a dedicated oversight capability
- Structuring input and output processes and workflow
- Establishing data requirements and exception processes back to the admin
- Standardisation and digitalisation of legal documents to drive efficiency

## *Technology*

- Utilising the workflow to orchestrate improved data movements and building linkages between systems
- Implementing a modular architecture with new cloud systems for the different areas e.g. portfolio monitoring, deal CRM
- Developing data warehouses with enhanced deal analytics and reporting capabilities for investor and board reporting

There is a typical inflection point in the growth of an asset manager that triggers the need for a re-evaluation of the operating model.




## Next steps

- The underpinning of Alternative firms' operating models is an area that is changing quickly as money flows into improvements in both the administrators and the technology.
- We anticipate big improvements over the next few years in these areas, but that doesn't mean you can stand still – the need to scale and industrialise is required now to meet investor and regulator demands.
- The scale of transformation means it is imperative to set out the future state operating model based on the growth strategy and to chart the course through the people, process, technology and sourcing decisions that need to be taken.

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# The new UK-Luxembourg double tax treaty

On 7th June 2022, the UK and Luxembourg signed a new double tax treaty and protocol which once ratified and enters into force, will replace the existing treaty dating back to 1967. The key impact of the changes in the treaty for investment funds are as follows:

- The UK will now have taxing rights over the sale of shares in UK property rich shares by Luxembourg resident companies
- Most dividends (except certain real estate linked dividends) will benefit from a 0% withholding tax.
- A clear definition has been provided for recognised pension funds and certain government entities. In addition, certain collective investment vehicles will also be able to benefit from the treaty.
- Tax residence for non-individuals will now be decided by mutual agreement of the tax authorities (and no longer by automatic change of place of effective management).

Further details of these changes and other minor changes are outlined below.

## Capital Gains Tax

Under the new treaty, gains derived by a resident of a Contracting State from the disposal of shares or comparable interests, such as interests in a partnership or trust, deriving more than 50 per cent of their value directly or indirectly from immovable property, situated in the other Contracting State may be taxed in that other State.

Since the introduction in the UK of non-resident capital gains tax in April 2019, the current UK Luxembourg treaty has continued to provide an exemption for Luxembourg entities selling shares in companies which are UK property rich (subject to certain anti-avoidance rules). Therefore this change has been anticipated since these rules came into effect. Although the treaty states a 50% threshold for the value of land being derived from property in the other state, the UK domestic law threshold is 75% which should be the effective threshold (as treaties should not create an additional tax charge above domestic law provisions). This change, along with other recent measures, continues to bring into line the taxation of non-residents investing in UK real estate compared to investment through UK structures.

## Dividend WIthholding Tax

Under the new treaty, most dividends which are beneficially owned by a resident of the other contracting state will be exempt from withholding tax. This is a welcome change to the existing treaty which only provides relief down to 5 or 15% depending on the investor. As the UK has no dividend withholding tax under domestic law (except REIT's – see below), the impact on dividends paid from the UK will be limited. Under Luxembourg law, dividends paid by companies which qualify for participation exemption will also be exempt, and whilst this exemption is wide ranging, since Brexit (EU recipients automatically qualify) there are instances whereby the UK parent company is either not equivalently taxed or has not met the holding criteria in order to the exemption to apply and has therefore suffered withholding tax on dividends from Luxembourg.

The only exception to the above, is for dividends paid by companies whose income is derived from immovable property, who distribute most of this income on an annual basis, and are exempt from tax on such income – such dividends may be subject to a withholding tax up to 15%. The key impact of this rule is to allow the UK to continue to collect 15% withholding tax on dividends paid by UK real estate investment trusts (REITs). The wording of this provision is not clear as to whether Luxembourg can also tax dividends paid by Luxembourg resident companies which hold UK property to a UK REIT parent company and so further clarity on this is being sought to confirm the position.

## Pension Scheme, State and Collective Investment Scheme Investors

The new treaty expands the definition of resident to include 'state and any political subdivision or local authority', as well as 'recognised pension fund' of each contracting state. The protocol then further defines 'recognised pension fund' to provide greater certainty.

The protocol to the treaty also provides that a Collective Investment Vehicles (CIV) established and treated as a body corporate for tax purposes in Luxembourg and which receives income arising in the UK shall be treated as resident of Luxembourg and beneficial owner of such income for purposes of applying the provision of the new DTT to such income if the beneficial interests in the CIV are owned by equivalent beneficiaries.

# The new UK-Luxembourg double tax treaty (continued)

Equivalent beneficiaries are referring to Luxembourg residents or residents of countries having signed a convention with the UK that provides effective and comprehensive information exchange and a rate of tax with respect to the item of income at stake that is at least as low as the rate claimed under the new DTT by the CIV with respect to that item of income.

Where 75% of the beneficial interests in the CIV are held by equivalent beneficiaries, or when the CIV is an undertaking for collective investment in transferable securities (UCITS) within the meaning of EU Directive 2009/65, the CIV shall be treated as a resident of Luxembourg and as the beneficial owner of all the income it receives (e.g. interest income).

These specific and extended definitions are a welcome change.

## Residence Tie-Breaker

In line with the current OECD recommendations, the residence tie-breaker for persons other than individuals will be changed such if a person is resident in both states under domestic law, then the residence whall be determined by mutual agreement between the states. This is a change from the effective management test in the existing treaty, albeit similar criteria may be taken into account under the new rules when the mutual agreement process is undertaken.

In line with existing UK policy, we do not expect HMRC to seek to change the residence determination of taxpayers who have changed tax residence prior to the treaty change, unless there has been a significant change in the facts since the original residence change occurred.

For future residence shifts, in order for certainty, tax payers may need to follow the ongoing UK consultation into corporate redomiciliations which may permit in future periods the legal redomiciliation into (and possibly out of) the UK which would if enacted, in most situations, mean there would not be dual residence for tax purposes in the first place.

## Other points to note

Under the double tax relief article, where a Luxembourg resident entity has dividends or gains in a UK property rich entity, then relief is provided by way of credit for UK tax paid rather than exemption in Luxembourg. Although the broad domestic law participation exemption may still be in point, taxpayers with this structure should beware of this change especially if the UK has exempted a capital gain which would not have qualified in Luxembourg (e.g. fund exempt elected gains).

The new treaty also fully incorporates the OECD recommended principal purpose test which means taxpayers can be denied treaty benefits if the main purpose of a transaction is to achieve that benefit. An equivalent provision has been active in the existing treaty since 2020.

# The new UK-Luxembourg double tax treaty (continued)

## Entry into Force

Although the treaty has been signed, it still needs to be ratified by both UK and Luxembourg governments. The treaty enters into force upon the completion of the ratification process, however it takes effect from the following dates:

## UK

For corporation tax (including the taxation of capital gains for Luxembourg companies in UK property rich shares) the treaty takes effect from 1 April of the financial year following the calendar year in which the treaty enters into force. Therefore provided the ratification process is completed by 31 December 2022, the capital gains tax changes will take effect from 1 April 2023 (please note the reference to financial year is to the UK tax definition of a financial year which runs from 1 April to 31 March – it is not a reference to a company's financial accounting period). If the ratification is not completed until 2023, then the capital gains tax rules will take effect from 1 April 2024.

Other UK changes take effect from 1 January following the entry into force for UK withholding taxes and 6 April for income and capital gains tax.

## Luxembourg

The treaty generally takes effect from 1 January following the entry into force (so for example, if the treaty is fully ratified before 31 December 2022, the new provisions on withholding tax etc, will take effect from 1 January 2023.

## Conclusion

Whilst the changes to capital gains tax were fully expected, the other changes to the treaty are generally welcome changes for both investment in UK real estate from Luxembourg, but also for real estate structures held by the UK (including under the new QAHC regime) where the investing entity in the real estate is in Luxembourg.

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# UK Economic Crime Act

## Register of overseas entities

The UK's Economic Crime (Transparency and Enforcement) Act 2022 ('the Act') came into force on 15 March 2022. A key element of the Act is the creation of a new public Register of Overseas Entities. This represents a significant shift in disclosure requirements for foreign companies who hold land or property in the UK. Similar to the UK's Persons of Significant Control regime ('the PSC Regime'), which requires the beneficial ownership of UK companies to be publicly listed, this new register will require the disclosure of those beneficial owners who own UK land or property through non-UK entities ('Overseas Entities').

### What overseas entities need to register

- Any body corporate as governed under the laws of its country of incorporation;
- Any Partnership as governed under the laws of its country of incorporation; and
- Any other entity governed by the law of its country which is considered a legal person under those laws.

### When will the requirement to register come into force?

The register will launch 1 August 2022, at which time the six-month transitional period will be triggered meaning Overseas Entities who already own land or property in England, Wales and Scotland must register during this time to avoid penalty.

The register will have retrospective application. For England and Wales, it will apply to all land or property purchased since 1 January 1999, and in Scotland since 8 December 2014. If the land or property was still owned on 28 February 2022 the Overseas Entity will have an obligation to register, even if the land or property has since been sold or leased.

The transitional period is intended to give Overseas Entities time to register. We urge businesses to start gathering the information that they need to comply with the register now.

In addition to the initial registration, there will be an annual compliance requirement to file a confirmation statement notifying of any changes to registrable beneficial owners or confirmation that the beneficial owners have not changed.

### What are the consequences of not registering?

Failure to comply with the registration obligations will constitute a criminal offence for the Overseas Entity and may also prevent the Overseas Entity from being able to buy, sell or mortgage UK land or property going forward.

For those Overseas Entities which transfer land or property in breach of the registration requirement, this will also constitute a criminal offence for both the entity and every responsible officer of it. This may lead to a fine or imprisonment for up to five years.

### What is the definition of beneficial ownership for these purposes?

The thresholds for beneficial ownership match those applied under the PSC Regime i.e.:

- Directly or indirectly holding 25% or more of the shares or voting rights;
- Directly or indirectly having the right to appoint or remove a majority of its directors; or
- Otherwise having significant control or influence over the entity (including through a trust arrangement).

### What information needs to be disclosed on the register?

It will be necessary to include information in relation to both the Overseas Entity itself and in relation to those identified as beneficial owner(s):

*Information required about the Overseas Entity*

a. Its name;

b. Country of incorporation or formation;

c. Registered office address;

d. Service address;

e. Email address;

f. Whether they meet the relevant conditions by virtue of being a trustee (conditions set out below); and

g. Whether they are a designated person within the meaning of the Sanctions and Anti-Money Laundering Act 2018.

# UK Economic Crime Act

*Information required about individual beneficial owner(s)*

a. Name, date of birth, nationality;
b. Usual residential address;
c. Service address;
d. Date on which the individual became a registrable beneficial owner in relation to the Overseas Entity;
e. Which of the beneficial ownership conditions are met, and a statement as to how they are met;
f. Whether they meet the conditions by virtue of being a trustee; and
g. Whether they are a designated person within the meaning of the Sanctions and Anti-Money Laundering Act 2018.

Where there are trusts in the ownership chain additional disclosure may be required in relation to the trust itself and the trustee(s). It will also be necessary to consider whether there may also be disclosure requirements in relation to either the settlor, beneficiaries or any other individuals related to the trust.

## Register of overseas entities: Our recommended approach

Structures that own land or property in the UK will need to have procedures in place to ensure they comply efficiently and comprehensively with the new rules in relation to the new Register of Overseas Entities. We generally recommend a risk-based response which includes the following steps:

*A. Conduct an impact assessment*

Determine the potential impact of the legislation on your structure and your disclosure and reporting requirements, as well as what steps you need to take.

*B. Due diligence*

Given the retrospective effect of the Act, you should analyse relevant historic corporate structures to determine the disclosures necessary for any overseas entities. This exercise should include conducting due diligence on land and property portfolios and the beneficial owners in order to determine the disclosures.

Identification of these points may not be a simple exercise, especially in the context of complex structures involving trusts. It is advised that advice is sought, as failure to comply within 14 days of the end of a 12-month update period may result in a daily default fine, which will be open to the public.

*C. Analysis of disclosure requirements and disclosure*

Based on the findings of the previous steps, you will need to make the necessary Companies House filings. As detailed above, failure to make annual declarations will carry penalties.

*D. Enhancements and ongoing compliance*

These may include the preparation of an implementation plan, to ensure appropriate registrations by appropriate dates as well as ensuring that the annual declarations as to any changes to registrable beneficial owners or confirmation that the information is up to date are made as required.

*E. Ongoing monitoring*

Structures should ensure that their compliance process is subject to routine review.

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# Hungarian financial transaction tax on cross-border services

## Background

The regulation on the extra-profit surtax expands the scope of transactions subject to the financial transaction tax (hereinafter: FTT). Investment firms, as well as credit institutions will become taxable after the purchase of a financial instrument with an ISIN code issued by KELER Central Depository Private Limited Liability Company for the benefit of a client account or own account. The scope of the rules are also expanding, persons performing these services, payment services, credit and loan granting, currency exchange activity and currency exchange intermediation services in Hungary as cross-border services will also be required to pay FTT. If these persons become taxable persons by 1 July 2022, they must request their registration as taxpayers with the Hungarian Tax and Customs Authority by 1 September 2022. If the foreign person becomes a taxpayer after 1 July 2022, the application for registration will have to be submitted by the 1st day of the month following the month in which the foreign person became a taxpayer. In general the tax rate is 0.3% of the value of the transaction but maximum HUF 10,000 per transaction. Taxpayers are required to submit monthly tax returns until the 20th day after the end of a month.

## Actions required by the cross-border service providers

As a first step it is essential to determine if the cross-border services provided in Hungary fall under the scope of the FTT. Foreign entities providing cross-border services that are subject to FTT in Hungary should prepare themselves for the following actions:

- Registration with the Hungarian Tax and Customs Authority for FTT purposes;
- Designing appropriate compliance processes;
- Preparing and submitting tax return;
- Processing the payment of FTT;
- Communication with the relevant Authorities.

## How do we approach the new rule?

As the actions, depending on the scale and volume of the activities, can be burdensome and require solid understanding of the local tax, legal and IT environment, it might be worth outsourcing the different tasks. PwC Hungary is ready to assist you with the following matters.

### *Impact analysis*

In order to determine if the cross-border services performed in Hungary are subject to FTT, we are ready to analyse domestic and EU legal background. In such analysis we also describe the relevant rules of the Hungarian FTT and highlight the areas (if any) that require consultation with the different authorities in Hungary.

### *Tax registration*

PwC Hungary is able to help with navigating through the whole tax registration process, including the preparation and submission of the relevant forms. Of course, our colleagues are able to reach out to the Hungarian Tax and Customs Authorities if any question arises during the process.

# Hungarian financial transaction tax on cross-border services (continued)

### *Compliance services*

If the required input data is provided to us, PwC Hungary is ready to support the cross-border service providers with preparing and submitting the FTT returns, as well as preparing the necessary underlying analytics.

### *Process automation – SMART tax solutions*

In order to minimise the administrative burden in relation to preparing and completing the FTT return form and statement, PwC's tax and IT experts are currently developing the 'FTT Tool' solution. The application will be able to provide end-to-end support from processing the transaction data to prepare the tax return in the required format, however the tool can also be used for separate tasks (e.g. only for preparation of the tax return).

This application can run on the Business user's laptops as a desktop software or can be hosted on the Company's servers as well. As far as the data input is concerned, two ways will be available:

- A file can be uploaded on a user interface by the Business users;
- Data can be sent through an API connection.

### *Consultation with the authorities*

In order to be able to design and execute an appropriate FTT compliance process, it might require consulting with the relevant authorities regarding uncertainties in the rules or the available IT environment. Our expert colleagues have extensive experience in discussing such matters with different authorities, therefore we are able to provide support for preparing technical meetings or assist in the process of preparing and submitting written ruling requests.

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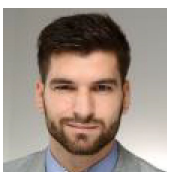

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