Keeping up with Tax - Alternative Investment Funds

February 2023

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Introduction

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

Excitement is in the air as we gear up for our **3rd annual Alternative Investment Funds Conference**, which will be held on **15 March 2022 from 12.30pm at our More London office**. This year's conference will feature plenary sessions with speakers and panels discussing PwC's expected megatrends of the next decade and our thoughts on managing and navigating recurrent crises and disruption. Key themes include: managing disposal to third party and next generation groups, tax risk policy, strategy and operations and what's next for carried interest? Attendees will also get a chance to network with industry colleagues and PwC's Alternative Investment Funds team over drinks and canapés.

If you have any questions, please send an email to uk_alternative_investment_funds@pwc.com. We look forward to seeing many of you there!

In the meantime, we have a great edition for our readers this month.

First up, **John Holt and Steven Anderson** call to attention the upcoming implementation of the European Anti-Tax Avoidance Directive 3 (**ATAD III**), which could be agreed as early as mid-year. ATAD III is designed to prevent the misuse of shell entities for improper tax purposes. The directive has been slow to progress since its inception in November 2021 and it is therefore likely that Member States will have little time to implement ATAD III (once finalised), presenting challenges to advisers and fund managers alike.

Next, **Laura Morris, Zack Goldberg and Pete Witton** explore the recent change in basis period for UK individual partners. This reform will have a significant impact for UK managers of alternative investment fund products using UK LLP structures with year ends other than 31st March/5th April.

Finally, **Pete Witton** shares his insight into the UAE as an up and coming hub for alternative investment fund managers and some of the key issues at play as individuals consider cross-border working and/or relocating to a UAE jurisdiction.

Please continue to reach out to your usual PwC contacts if you would like to discuss any of the content in this newsletter.

Thank you for reading and we look forward to connecting with you again next time.

Kind regards,

Seema & Fiona

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The Anti-Tax Avoidance Directive 3 (ATAD III) - The quiet before the storm

Not much has been seen of ATAD III recently. However, that doesn't mean it has gone away. Rather it's like a crocodile that has gone underwater. You know it's there and is coming your way but when and from what direction is uncertain. That makes it hard to prepare.

ATAD III is the so-called "Unshell Directive" aimed at stopping the use of shell companies within the EU to avoid tax. It also targets tax evasion and money laundering. Basically, the proposal is that shell entities that outsource activities and have inadequate substance will not be entitled to treaty or directive benefits.

The draft Unshell Directive was launched in November 2021. It has made slow progress as events and an economic crisis have taken up the EU's time. It does look possible that a Directive will be agreed mid year. However, it is now a tall order to expect Member States to implement this for the originally planned commencement of 1 January 2024.

The form of the Directive is subject to change. It originally envisaged targeting entities with cross border activities or asset holdings, where significant activities were outsourced. Unless such companies fell within certain derogations they would need to file a statement in their tax return declaring whether, and providing evidence, they met certain substance criteria (premises, bank accounts, staff). If not, they would be presumed to be a shell entity. Other EU countries could request that such claims of substance be audited by the relevant local tax authority.

These criteria did not really work. Much revolves around the detail of the wording. For example the original draft directive was triggered where "the undertaking outsourced the administration of day-to-day operations and the decision-making on significant functions". The EU Parliament has suggested the words "to a third party" be added to that test. If adopted, that simple change should exclude those structures where a local in-house entity provides the directors and back office support.

Unfortunately, whilst the Parliament's thinking is very visible, it is that of the Ministers and Commission that matters. That is more opaque. What is clear though is that they intend the directive will have real tax consequences and not to merely be an information exchange.

The envisaged consequences, at the very least, are the denial of benefits under the EU Directives and tax treaties with other EU states. Less clear is whether it will provide for EU member states to refuse to issue residency certificates to third countries.

Apart from the tax consequences, fund managers should consider how they would respond to investors seeking confirmation you do not use structures involving shell entities.

Unfortunately, there is only so much that a fund manager can do to plan for ATAD III ahead of an updated draft directive. For example, inserting a UK company in a chain to avail of treaty benefits is unlikely to work. Quite simply the "principal purpose test" will ensure that it is ineffective. A more likely step is to bring currently outsourced activities in-house but whether that will be effective depends on the wording of the final directive and local implementation. Until that is seen, a recruitment drive would be premature.

From where we stand now, it seems likely that ATAD III will (eventually) be successful in ensuring that assets are held in jurisdictions where there is genuine substance and fund management activity. Where this can not be done, holding structures, exits and realisation routes need to be planned that do not rely on treaty or directive benefits. This is quite possible in many cases.

The Anti-Tax Avoidance Directive 3 (ATAD III) - The quiet before the storm (continued)

It is worthwhile reviewing investments, identifying for each the likely exit horizon, exit steps and where treaties/directives are relied upon. Once the pressing exposures are identified, mitigation can be planned. That may involve making structures ATAD III compliant by insourcing functions and boosting substance or making exit plans that are ATAD III agnostic.

Once a directive is published, the evidence needing to be filed can be prepared and strength tested. Ultimately when the directive and relevant local implementations are available, an exit planned and any necessary evidence has been amassed, insurance may be possible. However, at this stage, the way ahead remains unclear.

ATAD III targets shell companies within the EU. The EU promised measures to target shells outside of the EU. It appears that these will take the form of a directive that targets the advisors, unhelpfully called “enablers”, considered to be involved in such structures. These will include professional advisers but also, it is likely, the London and US offices of fund managers making investments in Europe. A draft directive is expected in the middle of this year but options being considered include a requirement for “enablers” to register, follow a code of conduct, or diligence that arrangements they are facilitating do not lead to “aggressive tax planning”. At present, this is all very vague but will be one to watch and we will summarise in due course.

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Basis period reform - impact on Alternative Investment Fund Managers?

The Finance Act 2022 legislated changes to the way that business trading profits are allocated for income tax purposes in each fiscal (tax) year. These changes fully take effect from 6 April 2024 (i.e. the 2024/2025 tax year) but there will be a transition year starting in April 2023 (the 2023/2024 tax year).

This reform will have a significant impact for UK managers of alternative investment fund products using LLP structures with year ends other than 31st March/5th April, particularly those which generate the majority of their profits via fund performance fees paid by funds with calendar year ends.

What's the current position?

After navigating specific "opening year rules" and any potential "overlap profits", the current rules subject trading profits to UK income tax based on the profits for the accounting period ending in the tax year. For example, the profits for an LLP with a 31 December 2022 would be assessed in 2022/23.

What's changing from the 2024/25 tax year?

From 2024/25, partners in trading partnerships will be assessed on the profits which arise in the UK tax year 6 April - 5 April. For example, under the new rules, a partner in a trading partnership with a 31 December 2024 year end will be assessed in the 2024/25 tax year on 9 months of profits from the year end 31 December 2024 (i.e. April - December 2024) and 3 months of profits from year end 31 December 2025 (i.e. January - March 2025). This is instead of the 12 months to 31 December 2024 as is currently the case.

What are HMRC doing in preparation for the change? - The Transition period (2023/24)

2023/24 will be a transitional year. This will see partners be taxed on their normal 12 months of profits, plus a transition component running to 5 April 2024.

For a partner in a partnership with a 31 December year end, the 2023/24 tax year will include profits from 1 January 2023 to 5 April 2024. Any overlap profits brought forward and/or generated will be relieved in full in 2023/2024 and not carried forward into 2024/25 when the tax year basis will apply.

For individuals who are allocated higher profits in 2023/2024 due to the change in their basis period, the transitional period additional profits will be automatically spread over a period of five years, with the ability to elect out of the spreading and accelerate the charge by treating the additional amounts as arising in the 2023/24 tax year (which may be important to consider if obtaining double tax relief in another country).

Estimated profit share - Easements and HMRC consultation

HMRC consulted on a number of potential easements to deal with the challenges anticipated from the need to estimate partnership profits where the accounts have not yet been finalised.

HMRC recently announced that only one of the easements will take effect such that trading partnerships and partners will have a full 12 months to enable them to update provisional figures reported on their tax returns - this relaxes the current requirement where taxpayers are required to make amendments to provide final figures 'without delay'. This easement is not as beneficial as some of the other easements proposed, and will likely result in a number of issues and challenges for partnerships.

Key considerations

The changes will likely introduce complexities for businesses that do not have a 5th April or 31st March accounting year end, in that the accounts may not be finalised in advance of the individual income tax filing deadline of 31 January following the fiscal year, and for international businesses in relation to the interaction with overseas taxes.

There are a number of issues which are important to consider for both partnerships and individual partners that are impacted by the reform, as set out on the following page.

Basis period reform - impact of Alternative Investment Fund Managers? (continued)

- **Estimating and amending returns** - there will likely be a requirement to estimate a partner's profit on their tax return and then amend the return once the position is finalised. Taking an example of a partnership with a 31 December year end, for the 2024/25 UK tax a year a partner will need to include 3 months of profits from year end 31 December 2025 on their return. As the 2024/25 UK tax return deadline is 31 January 2026, this will leave only one month to estimate each partner's 3 months of profit from the year end 31 December 2025. This will be particularly difficult for managers receiving the majority of their remuneration from calendar year end fund performance payments, which may not be known/audited in time.
- **Late payment interest** - if the estimate on a partner's UK tax return is too low then the return will need to be amended at a later date, which could result in late payment interest (currently 6% p.a.). In addition, although unlikely, there is a potential for penalties to also be applied on the underpayment.
- **Foreign tax credits** - the UK tax return may also need to be amended for foreign tax credits. For example, partners of a partnership with a 31 December year end would currently include profits for the calendar year on their tax return, which in effect aligns their profit with the US tax year (and many other overseas jurisdictions) - this makes it easier to calculate the foreign tax credits available on the UK tax return. However, under the basis period reforms, the profit included in the tax return would no longer align with the US tax year as profits will be taxed in accordance with the UK tax year. This could create additional complexities in calculating the foreign tax credit available, as well as the need to amend returns when the overseas tax return is finalised.
- **Partner's compensation expectations** - under the new rules there will likely be a need to estimate each partner's profits such that the partner may expect their actual profit to be in line with the estimate - communications with partners on these estimates will therefore need to be effectively managed.
- **Transition year election** - as mentioned above, it will be important to consider whether a partner wishes to make an election in respect of the additional profits in the transitional year (2023/24 tax year) and the impact this will have on claiming foreign tax credits.
- **Enquiry periods** - if tax returns are amended in order to update the partnership profit, the window for HMRC to open an enquiry in respect of the partnership profits is extended for at least a year.

Changing to 31 March year end

One potential solution to the complexities arising from the basis period reform would be for partnerships to change their accounting period to be in line with the tax year i.e. 31 March year end. However, there are other factors to consider prior to making this change, including: overseas tax considerations, transfer pricing as well as the impact on audit and administration processes if group year ends do not match.

The basis period reforms and their potential impact on businesses and partners is significant, and it will be crucial for businesses to obtain advice on this as soon as possible to understand the impact and ways for managing the complexity.

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UAE - an up and coming hub for alternative investment fund managers

As travel re-opens after the coronavirus pandemic lockdowns, more and more fund managers are considering relocating staff and opening up new offices, both for business/strategic reasons and to respond to demand for flexible and remote working. In some cases, the relocation may include frequent travel back to the home country but in other cases, there may only be ad hoc return trips to the home country.

One of the locations which seems to have gained interest in recent months is the UAE so our commentary below looks at this country combination but the key issues that arise in all cases of cross-border working patterns.

When individuals move between the UK and the UAE, their own income tax position is, not surprisingly, front of mind. There is no personal income tax regime in the UAE whereas UK income tax can reach up to 45% so getting a handle on the overall tax position is very important and often a sensitive matter in terms of understanding and managing cash-flow. These considerations become even more important when an individual is spending time working across both the UK and the UAE concurrently.

When an individual moves to the UAE for employment purposes and ceases to be UK tax resident or spend time working in the UK, they would generally fall out of the scope of UK income tax in relation to their UAE employment income. The notable exception is trailing liabilities such as bonuses or deferral awards which are awarded in relation to services undertaken in the UK. For example, if an individual moves to the UAE on 1 January 2023 and ceases to be tax resident in the UK from 31 December 2022, but receives a bonus in relation to the 2022 calendar year in February 2023, that bonus is generally taxable in the UK, despite being received whilst non-resident. From a personal tax and employment tax perspective, it does not matter whether a UK or UAE entity makes the bonus payment. Similarly, an individual who moves to the UK on 1 January 2023 and receives a bonus in February 2023, may find that none of that bonus is taxable in the UK since it relates to a time when the individual was non-UK tax resident. Where an individual moves during the performance period (i.e. during calendar year 2022 in the example above) in relation to which a bonus is paid, a pro-rata calculation over the earnings period of the bonus is normally undertaken to determine where it is taxed. Deferrals will typically have a longer earnings period depending on the specific terms of the award. US nationals and Green-card holders remain taxable in the US on a worldwide income basis, irrespective of where they reside and so, upon moving to the UAE, they may not be able to afford the full benefit of the lack of income tax regime. Many US taxpayers, however, who have resided in the UK for many years, may have a build up of excess foreign tax credits which they can use to help reduce US taxes in the immediate term.

In both of these examples, care needs to be taken if they undertook any UK work days whilst based in the UAE and we would need to consider whether those workdays should be taxed in the UK, or whether they are eligible for exemption from UK income tax under the terms of the UK/UAE double taxation agreement and/or whether they should be included on the UK entity's annual Short Term Business Visitor filing with HMRC. Similarly, for personal reasons, individuals may spend a period of time commuting between the UK and the UAE before fully moving to the UAE. During that interim period, individuals will need to consider whether they remain or re-establish UK tax residence and the income tax and employment tax consequences in either case.

UEA - an up and coming hub for alternative investment fund managers (continued)

Sign-on bonuses can often result in unexpected income tax treatments since in the UK, they are generally treated as earnings for the UK tax year in which they are received. This treatment means that if someone is planning to move to the UAE to take up employment with a new employer and receives a sign-on bonus prior to their move (whilst still a UK tax resident), there is a risk that a portion of the sign-on bonus may be taxable in the UK. In practice, we have seen such cases where the sign-on bonus is paid upon agreeing to join and perhaps during a notice period for another employment (i.e. some months prior to commencing the new employment), and also where the move to the UAE is delayed for personal reasons and the individual works remotely for the UAE employer from the UK for some months before actually moving. Clawback arrangements on sign-on bonuses and other long-term reward arrangements can also give rise to complexities in the tax treatment. As always, consideration must be given to the precise facts and circumstances in each case taking into account the reason for the award, the award's terms and conditions and the employer's typical treatment of comparable awards.

From a social security perspective, there is no social security agreement between the UK and the UAE. That means that secondees (and their employers) between the UK and the UAE will be subject to a 52 week continuing liability to UK National Insurance contributions (NICs) for UK outbounds, and a 52 week exemption from UK NICs for UK inbounds.

For individuals who are LLP members in the UK and then move to the UAE to take up employment with a UAE entity in the group, individuals generally leave the UK LLP. In these cases, the 'closing year rules' for partners apply and any overlap profits which were created in the year that the individual joined the partnership would be relieved in the closing year. In some cases, it may be preferable for the individual to remain within the LLP and this approach can be particularly useful when the LLP member will continue to receive deferrals from the partnership. In such cases, the individual typically becomes a non-active or restricted partner.

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Thank you