Keeping up with Tax – AIF

June 2023

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Welcome

“Summer afternoon – summer afternoon; to me those have always been the two most beautiful words in the English language.”

- Henry James

Summer is upon us, my favourite time of year! A time for inspiration; for new beginnings. And, for many of us, a time for some much needed rest and relaxation.

Our June edition of Keeping Up With Alternative Investment Funds kicks off with some thought-provoking insights from **Ignas Matevicius** and **Roman Thames** into the new challenges asset managers face when undertaking the transfer pricing analysis for financial transactions.

Next up, **Charlotte Thackrah** and **Joe Hudson** delve into the Economic Crime and Corporate Transparency Bill, which will receive Royal Assent this month and is due to come into force sometime in 2024. The Bill seeks to reform the role and powers of the Registrar of Companies in a bid to tackle economic crime and improve transparency over UK companies. Importantly, for clients who use UK limited partnerships in their fund and investment structures, the Bill will introduce new verification requirements and additional compliance requirements.

To wrap up, **Leo Humphries**, **Uneeb Khalid**, **Priya Patel**, **Harry Kwok** and **Paul Oliver** navigate the accounting impairment on debt investments in a UK direct lending platform entity, and explore potential alternatives where an impairment is likely to be required..

Charitable Fun(d!) Run

On 27 May, led by Tunde Ogunlesi, 12 members of our PwC team successfully completed the Fox Hill Half Marathon in aid of the **Help for Children UK** (“HFC”). The team has so far raised an outstanding £9,500! You can find out more here.

HFC has globally raised over $58M since inception and touched more than 1 million children’s lives. HFC hosts networking events which are supported by the alternative investment industry and so is closely aligned to the financial services sector.

Congratulations to all the participants on their incredible achievement!

Save the Date - In Person Conference Coming Soon…

In an unexpected turn of events, our annual AIF conference will now take place on Thursday 12 October 2023

Invitations will be sent out in the near future so if you’re not already subscribed to our mailing list and want to receive your invitation, please reach out to your usual PwC contact or drop us an email at uk_alternative_investment_funds@pwc.com.

We look forward to meeting with you in person again at the conference!

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

Wishing you all a lovely summer

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Rising to the Challenge – Rethinking Financial Transactions

Introduction

Recent changes in economic conditions and regulatory trends means (1) tax departments cannot rely on practices and rules of thumb established during the preceding decade and (2) that transfer pricing ("TP") analyses for financial transactions performed recently as a few years ago can be outdated.

Central banks have been raising rates to fight inflation, which has also led to a flattening of the yield curve. This rise in interest rates as well as the anticipated downturn in the global economy have contributed to a decrease in the level of new debt issuances. Rising interest rates have caught out a number of banking groups off-guard raising concerns of further disruption in the financial sector.

These factors are contributing to a complex economic landscape, which presents a number of challenges and opportunities with respect to pricing intercompany financing transactions. Asset managers should take note and review their policies and intercompany positions.

Arm's length terms and conditions

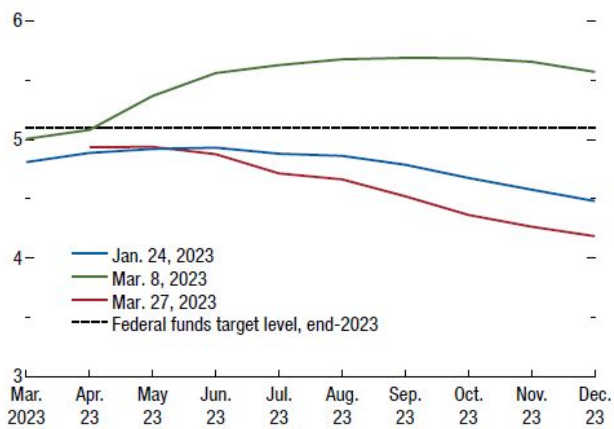
Recent case law brings the UK in line with a long-standing trend of tax authorities placing ever greater focus on the substance of the transaction and expecting intercompany contracts to mirror third party terms and conditions more broadly (i.e. not just the interest rate).

Last year, the upper tribunal ("UT") handed down its decision in the Blackrock appeal[1]. The UT upheld HMRC's decision to disallow c. $4bn of interest expenses on intercompany debt on the basis that the loan agreement did not reflect third party terms and conditions. Specifically, the agreement did not contain financial covenants which, based on expert witness, would have been in place in equivalent transactions between third parties.

It is not expected that all intercompany loan agreements without covenants will be challenged; however, this does open the door for HMRC to challenge transactions which are deemed 'high-risk'. In the asset management space, this may include conduit onlending, upstream loans, joint venture debt and other transactions where the lender does not have control over the borrower.

In a low interest rate environment, businesses often looked to borrow as much as possible for as long as possible to take advantage of cheap credit. Elevated interest rates change the incentives for borrowers. As interest rates are expected to go down over the short/medium-term - either because inflation is brought under control or central banks are forced to ease policy due to financial distress - borrowers are incentivized to either borrow for shorter time frames or have flexibility in the loan terms to refinance at a favourable rate before maturity (see Chart 1).

Chart 1. Market-Implied US Policy Rate Expectations (annualise percent)



Source: World Economic Outlook, IMF, April 2023

It is therefore important to consider what terms and conditions are appropriate when issuing new intercompany debt or refinancing existing loans. For example:

- What is an appropriate tenor? Are shorter term loans more attractive given the expectation of falling interest rates? On the other hand, as long-term and short-term interest rates have converged, does it make sense to borrow longer-term to have certainty over costs of capital as there is no longer any premium compared to short-term debt (see chart 2)?
- Would a third party borrower prefer a floating interest rate given the expectation of falling interest rates?
- Would a third party borrower seek an early repayment option to have the flexibility to take advantage of falling interest rates? If so, what is an appropriate penalty associated with such options and what is the impact on the loan interest rate?

[1] https://thesuite.pwc.com/insights/blackrock-holdco-5-llc-v-hmrc-upper-tribunal-decision

Rising to the Challenge – Rethinking Financial Transactions (continued)

Chart 2. Yields on 1, 5 and 10 year USD corporate debt

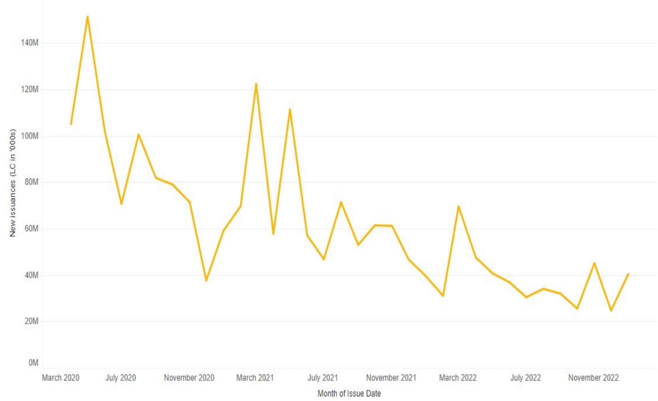
Source: Refinitiv Eikon

Thin capitalisation

Asset managers should consider whether entities with intercompany liabilities are sufficiently capitalised when new transactions are being introduced, however, given the changes in market conditions even transactions documented within the last few years should be reassessed.

As lending conditions tightened since early 2020, corporate debt issuances have slowed down (see Chart 4).

Chart 4. Amount of USD corporate debt issued by month



Source: Refinitiv Eikon

In an environment where businesses are finding it more difficult and less attractive to raise debt, in order to evidence that the quantum of intercompany debt is arm's length, a simple leverage analysis may no longer be sufficient. In order to demonstrate that they have taken reasonable care, asset managers may need to be able to point to specific market comparables, i.e. are companies in my peer group with a similar risk profile actually issuing an equivalent amount of debt?

Furthermore higher interest rates also call into question analyses which have been performed over the last few years.

Higher operational costs and higher funding costs puts pressure on serviceability ratios from both sides, especially on floating rate instruments. At the same time, elevated interest rates and dampened economic growth prospects have knocked down valuations of various financial instruments (bonds, stocks, real estate etc) reducing the value of potential collateral putting leverage analysis at risk.

The above means that a significant portion of analyses performed to justify the amount of intercompany loans even in the recent past will not hold up in today's high interest rate environment. In a third party context, this would likely result in a breach of covenants. Intercompany loans often don't have covenants (which may be an issue in its own right in the context of the Blackrock case as discussed above), however, tax authorities may argue that such covenants should have been in place and, upon a breach, would have triggered debt restructuring with potential write-offs bringing the amount of debt closer to current market conditions. Accordingly, asset managers would do well to review the analysis underpinning the debt quantum on their intercompany loans and assess whether it still holds up.

Conclusion / next steps

Given the significant changes in the macroeconomic environment and volatility in the financial markets, now is a good time for asset managers to perform a review of their intercompany loan portfolio, focusing on the substance of the transactions and challenging previous assumptions.

Rising to the Challenge – Rethinking Financial Transactions (continued)

How can PwC assist?

We have been advising asset managers on designing TP policies for financial transactions which can adapt to evolving market conditions. Designing a comprehensive and flexible policy upfront means that less work is required down the line.

We also helped a number of groups with a large number of intercompany transactions to implement technology-driven automation solutions focused on financial transactions in order to manage the cost of addressing the challenges presented by the evolving market conditions and shifting regulatory environment.

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The Economic Crime and Corporate Transparency Bill

Overview

The Economic Crime and Corporate Transparency Bill (the "Bill") forms part of the Government's armoury to tackle economic crime and improve transparency over UK companies and other legal entities by reforming the role and the powers of the Registrar of Companies House (the "Registrar") and UK Companies House. The Bill is intended to reform the role of the Registrar in order to strengthen the business environment, support national security and combat economic crime in order to make the UK a more attractive place to do business.

The Bill will introduce wide ranging changes for UK companies and other legal entities, such as Limited Partnerships formed under the Limited Partnerships Act 1907 ("UK LPs"). The key changes include:

- new identity verification requirements for directors, partners (including registered officers of the partner if the general partner is a legal entity), People with Significant Control ("PSCs") and those who deliver documents to Companies House;
- introduction of the concept of an Authorised Corporate Services Provider ("ACSP") who will be authorised to undertake the verification requirements and make filings at Companies House on behalf of companies and UK LPs;
- new statutory compliance obligations and stricter registration requirements for UK LPs which have previously been subject to minimal compliance requirements.

To underpin these changes the Registrar will see its powers broadened with more effective investigation and enforcement powers over directors and UK legal entities.

The Bill is currently at Report stage and it is expected that it will receive Royal Assent in June 2023, coming into force in 2024. Once the Bill comes into effect, there will be a transitional period for existing companies to meet the identity verification requirements and a transition period of six months for existing UK LPs to become compliant with the provisions of the Bill.

What's changing?

New verification requirements

The Bill will introduce a host of changes to the way in which legal entity structures are governed which will apply to any clients who utilise UK registered companies and UK LPs in their fund and investment structures. Significantly the introduction of identity verification requirements for all new and existing registered directors, PSCs and anyone delivering documents to Companies House. This will make it much harder to register fictitious directors or PSCs.

It will be possible for identity verification to be undertaken via Companies House or via an ACSP. ACSPs are likely to be intermediaries such as accountants, legal advisors and company formation agents, they will be able to deliver documents to Companies House on clients behalf, and undertake the verification process. Alternatively, in order for a person to file documents with the Registrar directly they will need to verify their identity before doing so. We expect that this will lead to an increase in the use of ACSPs to deliver documents for UK registered companies and UK LPs on client's behalf.

Individuals who fail to comply with the identity verification requirements could be subject to criminal proceedings and civil penalties issued by the Registrar as well as resulting in Companies House declining to register documents.

Additional compliance requirements for UK LPs

For those clients who use UK LPs in their fund and investment structures, the Bill will introduce a wide range of additional compliance requirements as set out below and there will be a substantial increase in the amount of information to be notified to Companies House. Whilst these changes will impact all UK LPs those with a large number of individuals participating as limited partners will be particularly impacted by the need to notify Companies House of information about residential addresses and dates of birth. It should be noted that these changes will also impact Private Fund Limited Partnerships ("PFLPs"), with some minor differences.

The Economic Crime and Corporate Transparency Bill (continued)

PFLPs which were registered as a UK LP prior to 6 April 2017 will be required to give notice of a limited partner's withdrawal of their contribution where that withdrawal reduces the amount of the partner's contribution below the contribution amount on the date on which the UK LP was designated as a PFLP.

These changes whilst largely administrative in nature, will represent a significant change for UK LPs as currently there are limited compliance requirements for UK LPs within the UK, with fewer administrative burdens and ongoing filing obligations with Companies House than for a UK registered company. Significantly, much of the information that UK LPs will be required to file with the Registrar must be submitted by an ACSP rather than an individual.

The key changes include:

Key area	New Requirements
ACSP	Certain documents (including applications for registrations, change of registered office address and changes to the details of officers of the general partner) will only be able to be delivered to Companies House by an ACSP.
Registered Officer	UK LPs will be required to have a registered officer appointed at Companies House, which will be a member of the General Partner. There will be requirements to keep data up to date relating to the registered officer.
Registered Office Address	All UK LPs will be required to have a registered office address and a principal place of business within the United Kingdom. The registered office address will need to be the principal place of business, the usual residential address of a general partner that is an individual, the registered office address of the general partner or an ACSP.
Annual Compliance	Confirmation Statements: All UK LPs will be required to submit annual confirmation statements to Companies House.
Dissolutions	New legal procedures will be introduced to manage the dissolution / deregistration of UK LPs, and there will be notification requirements to Companies House to this effect. The notification processes will need to be followed to ensure that the Partners retain their limited liability. UK LPs will be dissolved if they cease to have a General Partner or a Limited Partner.

What does this mean for our clients?

Clients should take steps now to:

- Understand the extent to which the Bill will impact the UK registered companies and UK LPs in their group and assess the costs of meeting the requirements.
- Review their corporate structures to identify any UK companies or UK LPs which are no longer required in order to reduce their compliance burden and costs ahead of the Bill coming into force.

PwC can work with clients to help understand the impact of the Bill. We can also assist clients in reviewing corporate structures and provide support with restructuring and, where required, elimination of any surplus entities including UK LPs.

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Navigating Impairments in UK Direct Lending Platforms: Key Tax and Accounting Considerations

Introduction

To the extent there is an accounting impairment on debt investments in a UK direct lending platform entity, navigating the tax implications can be challenging. In particular, ensuring that the overall performance and investment returns are not distorted due to tax leakage arising from the interaction of accounting and tax rules.

Taking a regular UK incorporated and tax resident company ("**UK FinCo**") as an example, we will outline some of the key considerations if its debt investment is subject to impairment. We will consider a common structure, which is where a UK FinCo is owned by a pooling investment vehicle, typically a transparent entity (the "**Fund**"), with a performing, loan origination investment strategy.

Generally in these structures, UK FinCo is funded with debt (typically an interest bearing loan) from the Fund which it uses to originate third party loans. UK FinCo is typically subject to corporation tax on an arm's length margin which is based on its functional and risk profile and aligned with the transfer pricing rules in the UK.

When is an impairment required for accounting purposes?

Taxation for "loan relationships" (such as the assets and liabilities of UK FinCo) generally follows accounting profit and loss, so the first step is considering when an impairment is recognised from an accounting perspective and whether there is a profit and loss impact to this.

Impairments of financial assets are required to be considered only when measured at amortised cost, rather than at fair value through profit and loss / other comprehensive income. Financial liabilities measured at amortised cost are not tested for impairment (as the liability on the balance sheet reflects the contractual obligation and so does not reflect own credit risk).

Under International Financial Reporting Standard 9 ("IFRS 9", the replacement of the previous financial instruments standard, International Accounting Standard 39, "IAS 39") financial assets are measured at amortised cost when both (i) the entity meets the business purpose test (assets are held to collect contractual cash flows only) and (ii) the cash flows of the asset meet the SPPI (solely payments of principal and interest) criteria. It may also be possible to elect (as a policy choice) to use fair value accounting under IFRS 9 where to do so would eliminate an accounting 'mismatch' between assets and liabilities accounted for at fair value.

Under The Financial Reporting Standard Applicable in the UK and Republic of Ireland 102 ("FRS 102") of UK Generally Accepted Accounting Principles ("GAAP"), financial assets are only measured at amortised cost if they meet the criteria of a basic financial instrument (provided a policy choice available under UK GAAP to adopt IFRS 9 or IAS 39 for financial instruments accounting is not applied). Other financial assets under UK GAAP would otherwise be classified as complex and measured at fair value.

Impairments under IFRS 9 are based on an expected credit loss model (i.e. a forward looking approach), whereas UK GAAP (FRS 102) (and also IAS 39) is based on an incurred loss model. Therefore, under IFRS 9 credit losses / impairments will generally arise earlier in the assets lifecycle.

For UK incorporated entities, impairment losses are recognised in profit and loss and are generally treated as realised losses (and therefore reduce the entity's distributable profits).

For completeness, when considering the accounting treatment for investment assets held in a UK FinCo under a Fund it is also often necessary to consider whether the entity meets the definition of an investment entity under IFRS 10.

Where it meets the definition of an investment entity then it would be expected to account for its investments (both in debt and equity) at fair value, with some limited exceptions. A similar analysis would also need to be undertaken under UK GAAP (FRS 102).

Navigating Impairments in UK Direct Lending Platforms: Key Tax and Accounting Considerations (continued)

Key tax considerations on impairments

If it has been determined that there is likely to be an impairment expense recognised for accounting purposes, from UK FinCo's point of view, the below two questions should be considered:

Is an impairment or a reversal of an impairment on a loan relationship subject to the corporate interest restriction ("CIR") rules?

Although the term "impairment" is not specifically defined in regulations, HMRC guidance CFM95190 notes that it should take the normal accountancy meaning.

If, for accounting purposes, there is an impairment, any impairment loss on loan relationships should be excluded from the tax interest expense amount. Therefore, an impairment on loan relationships should not be subject to the CIR rules and should be an allowable loan relationship expense.

Given the tax profile of a UK FinCo, being taxable on an arm's length margin, such expense is likely to create a loss in the year and subsequently carried forward if not utilised in full (which we would generally expect in a performing strategy).

Any reversal of an impairment should also fall outside the CIR rules and should be taxable as a loan relationship credit without offsetting tax interest expense.

This will then lead to the second point, the impact of the corporate loss restriction ("**CLR**") rules on the impairment loss and any reversal of impairment income.

What is the CLR impact on the impairment loss?

As mentioned above, generally, we would expect an impairment to have no direct impact on the level of interest income and expense accrued. Interest received should generally follow the contractual obligation of the loan.

As such, UK FinCo should broadly be able to maintain its arm's length margin, while any impairment loss recognised exceeding the margin should lead to a carried forward loss.

A loan relationship deficit (which should be the classification for an impairment loss) should be subject to the CLR rules. Broadly, the CLR rules impose a 50% restriction on the amount of profits over £5m against which carried-forward losses may be relieved.

In the event of a reversal of the impairment in subsequent years, to the extent this is greater than the CLR de-minimis threshold, 50% of any excess should be subject to UK corporation tax. As such, broadly 50% of the recovery on the principal of the underlying loan (representing a reversal of the impairment) could be subject to tax.

To the extent the carried forward loss is utilised in full over the life of the loan (for instance, to offset against the taxable arm's length margin) the tax leakage may be a timing issue, resulting in annual cash tax volatility (we would not expect the transfer pricing position determined on loan origination to change). Management would therefore need to include (at a minimum) cash tax volatility and/or (potentially) permanent cash tax leakage as part of modelling their returns.

Alternative structures and considerations

Generally, as UK direct lending platforms are established to manage performing debt investments and not investments which could be subject to impairment, from a commercial, legal and tax perspective alternative structures may be considered if an impairment is likely to be required.

UK FinCo taxed under the UK Qualifying Asset Holding Company ("QAHC") regime

To the extent there are any impairments when a UK tax resident company is subject to the QAHC regime, (where the assets and liabilities are recognised on an amortised cost basis) any impairment loss carried forward that was incurred from the ring fenced business (i.e. the qualifying QAHC business) is not within the scope of the CLR provisions. Therefore, there should be no restriction on utilising the loss in full to shelter a reversal of the impairment in subsequent years.

As a result, this should mitigate cash tax volatility arising from impairments and maintain returns on the investment, in a treaty eligible platform.

For completeness, we note that if a UK FinCo elects into the QAHC regime subsequent to an impairment being recognised, such impairment loss cannot be used to offset the reversal of impairments where the loan is within the QAHC ring fence business.

Direct lending funds considering the QAHC regime would need to satisfy certain eligibility criteria. In practice, for a direct lending strategy, one of the key criteria is the ownership condition. Broadly, the ownership condition requires that not more than 30% of the relevant interests in the QAHC are held by investors who are not Category A investors.

Navigating Impairments in UK Direct Lending Platforms: Key Tax and Accounting Considerations (continued)

If it has been determined that there is likely to be an impairment expense recognised for accounting purposes, from UK FinCo's point of view, the below two questions should be considered:

Category A investors include other QAHCs, a "qualifying fund" and a "qualifying institutional investor". "Intermediate companies" may also qualify provided they meet particular activity and ownership conditions.

The other criteria to be met are:

- **Residency condition** - the company must be a UK tax resident;
- **Activity condition** - the entity's main activity is carrying on an investment business (and other non-substantial activities are ancillary to that of the investment business);
- **Investment strategy condition** - the strategy does not involve the acquisition of listed equity securities, or interests that derive value from such investments;
- The company should not be a UK REIT;
- **Listed/traded equity securities condition** - the equity securities of the company are not listed or traded on a recognised stock exchange or any other public market or exchange; and
- An entry notification is made to elect into the regime.

Following entry into the QAHC regime, where the debt funding the QAHC is in the form of a profit participating loan ("**PPL**") it should be considered further how this is accounted for. For instance, if this is fair value accounted for and if the corresponding assets are fair value accounted for. Under fair value accounting, impairments of financial assets are not required and generally gains or losses may be offset where both the asset and liability are fair valued.

For more details on QAHC, you can refer to our article on QAHC in the **KUWAIF January 2022 edition.**

Transfer the impaired third party loan asset from UK FinCo to a related entity

For commercial and legal reasons, a decision may be made to transfer out the impaired debt (for example to ring fence any enforcement proceedings in a separate legal entity). For UK FinCo, where an impairment loss is recognised and there is a corresponding release on the debt funding of UK FinCo, this could result in a neutral position for UK FinCo if both take place in the same accounting period. However, any source country withholding tax on interest payments made from the underlying borrower to the new lender will need to be considered.

In addition, investor implications on the transfer and future reversals of impairments as well as the appropriate form and jurisdiction of any separate vehicle established to acquire such impaired debt, plus any wider impact on the fund structure will need to be considered.

Fair value accounting

At the outset, when establishing UK platforms, it could be considered whether fair value accounting of the assets and liabilities is possible and commercially feasible. As noted above, impairments of financial assets are required to be considered only when they are measured at amortised cost and not fair value.

Conclusion

If UK FinCo can meet the above mentioned QAHC eligibility criteria, the UK QAHC regime is an attractive alternative to ensure that any accounting impairments recognised do not result in an uneven economic loss or cash flow volatility, provided this is undertaken in advance of impairments being recognised.

To the extent the underlying third party loans do in fact commercially and economically become "distressed debt", then further consideration may be required.

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Thank you

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