Baker McKenzie.

The latest tax news and developments for fund managers

FTB No. 9 (May 2022)

The UK and international tax landscape has never been quiet for fund and asset managers ("**GPs**") but a number of recent tax developments will have the potential to significantly affect how these businesses operate. Some of these developments will, however, be welcome by most GPs.

In this edition of the Fund Tax Bites newsletter we have produced a "bite-size" summary of the key recent developments that are likely to affect the GPs.

International and EU Tax Developments

Tax substance considerations (ATAD 3)

On 22 December 2021, the European Commission published its proposal for a directive to prevent the misuse of shell entities (including companies, partnerships and trusts) for tax purposes ("**Proposal**"). The purpose of the Proposal is to discourage the use and creation of shell entities within the EU. The Proposal requires taxpayers to report information that will enable the respective competent authority to assess whether the entity has a real and substantial presence and economic activity in the respective jurisdiction. Treaty benefits granted under EU law may be denied in case of absence of real and substantial presence and economic activity. The Proposal is likely to be implemented later in 2023 and the directive will then take effect shortly thereafter.

A further proposal covering non-EU shell entities is also expected during the course of this year.

Although many have flagged the uncertainties about certain concepts in the Proposal and the need for more clarifications, it is likely that the Proposal will be adopted (either as is or in an amended form). As such, the GPs are strongly advised to carry out an assessment of their corporate structures and consider whether any of the entities in their structures may need to report or whether they can avail from an exemption (for example, regulated investment funds should not be affected; however, non-regulated investment vehicles may, subject to ongoing consultation, be in scope). This is because the Proposal contains a two-year "lookback provision", which means that any structures in place in 2022 may be relevant for the purposes of the directive once implemented.

Profit allocation to source countries (OECD Pillar I)

Earlier this year, the OECD released the draft model rules under Pillar I. The rules will require the largest multinationals to pay a certain level of taxes in the jurisdictions where their customers are located. They will seek to do this by adapting the international tax system to new business models through changes to the profit allocation and nexus rules applicable to business profits. This effectively expands the taxing rights of market jurisdictions where there is an active and sustained participation of a business in that jurisdiction's economy.

The regime will apply to multinational groups with global consolidated turnover of more than EUR 20bn (or local equivalent) and profitability above 10%, provided they do not fall within an exclusion.

Although not yet agreed, the exclusions are expected to cover different industries, including regulated financial services (in this regard, on 6 May 2022 the OECD released a public consultation document covering the exclusion of the regulated financial services from Pillar I; it is notable that some countries do not think that asset management should be exempt[1]).

The regime is expected to come into force in 2023.

Even though most investment funds are likely to fall outside the scope (either because of the size of the business or because of an exclusion), the GPs are nevertheless advised to consider how Pillar I may apply to their structures or potentially the investee groups (to the extent the rules may have an impact on the overall returns from the investee companies).

Global minimum tax (OECD Pillar II)

In December 2021, the OECD published draft model legislation for a new global minimum tax regime known as the Global Anti-Base Erosion rules. The rules aim to ensure that profits of large multinational groups (*i.e.* those with consolidated revenues exceeding EUR 750m) earned in every jurisdiction where the groups have operations will bear an effective tax rate of at least 15%. This will be done through a number of mechanisms allowing implementing jurisdictions to apply a "top-up tax" and bring the effective tax rate up to 15%. The rules are likely to take effect from 2023.

The UK launched a separate consultation exploring the implementation of the Pillar II model rules to introduce a global minimum tax and a UK minimum tax (where the Pillar II rules might otherwise allocate the taxing rights to another country).

Although investment funds are specifically excluded, the draft rules are complex and GPs should consider whether the requirements for any specific exclusions (as interpreted by the relevant commentary) can extend to their funds and/or whether there is a consolidated group that would trigger the threshold.

UK Tax Developments

New asset holding company regime

With effect from 1 April 2022, a new qualifying asset holding company ("**QAHC**") regime was introduced in the UK to offer a more beneficial tax treatment for eligible asset holding companies established in the country. To benefit from the QAHC regime, a company must be an unlisted UK tax resident company which is at least 70% owned by certain "good" investors and satisfy a number of other conditions[2].

The new regime is an exciting development and will allow the UK to compete with rival European fund centres, in particular Luxembourg and Ireland. Its availability will be particularly welcome for many managers who are based in the UK and have been concerned about the need to build (or increase) substance in other jurisdictions where their fund structures are located, especially in light of ATAD 3.

Consultation on VAT treatment of fund management fees

As part of its wider review of the UK funds regime, the government has recognised that the competitiveness of the UK's VAT regime is a necessary condition for the country to be considered an attractive location to domicile funds. Although in a recently published response document the government indicated its decision not to apply a VAT zero-rate to all fund management fees, primarily due to the significant impact this would have on the Exchequer, HMT and HMRC are nevertheless working towards a

[1] Please refer to our legal alert on 10 May 2022 for further detail on this topic: https://insightplus.bakermckenzie.com/bm/tax/international-pillar-one-draft-model-rules-for-regulated-financial-services-exclusion-published

[2] For more detail on the regime please refer to FTB No. 8 (January 2022).

consultation on the VAT treatment of fund management fees.

The consultation, which is expected to be published in the coming months, will explore other options to simplify and improve the VAT regime in relation to fund management.

Notification of uncertain tax treatment

For any returns filed after 1 April 2022, there is a requirement for businesses to notify HMRC of uncertain tax treatments adopted. Uncertain treatments are defined by reference to two criteria:

- a provision has been made in the accounts for the uncertainty; or
- a position was taken by the business that is contrary to HMRC's "known" interpretation.

The requirement to notify is subject to a £5m *de minimis* threshold per tax and per year. Collective investment schemes and alternative investment funds are expressly excluded, and the rules only apply to large businesses (broadly, turnover above £200m per annum and/or a balance sheet total over £2bn) but large GPs may still be in scope and, therefore, have to consider whether they need to make a notification.

Increased focus on tax disputes

As mentioned in our recent report "Risk Reshaped: Tax Disputes Outlook"[3], the volume and value of global tax disputes is rising. Drawing on an independent survey of 1,200 leaders in 10 jurisdictions and across six industry sectors (including financial institutions and asset managers), the report records that 76% of tax leaders saw an increase in the value of tax disputes during the course of last year, and 75% agree that this figure will rise again in the coming years.

Considering the ever-increasing number of targeted anti-avoidance provisions being implemented in the UK, and coupled with the additional investment into HMRC's compliance and debt management capacity, GPs should carefully consider their structuring arrangements to ensure they are compliant with an ever-increasing body of tax rules. This is especially pertinent in the context of compliance with the UK carried interest tax rules: we are increasingly seeing HMRC audits and enquiries into personal and corporate tax returns in relation to the application of these rules.

New UK long-term asset fund structure

Long-term asset funds ("**LTAFs**") are a new category of UK authorised open-ended funds able to invest in long-term illiquid assets, such as private equity and venture capital, private debt and other strategies that may be used for long-term investment. The purpose of the LTAFs is to effectively open up the existing closely-held long-term investment structures to a much broader investor base.

From a UK tax perspective, provided that an LTAF meets the genuine diversity of ownership condition (broadly, at least 70% of the fund is held by specified investors, such as defined contribution pensions schemes), the fund will be exempt from UK tax on chargeable gains. The tax on any gains realised from capital transactions are instead deferred until an investor disposes of units in the LTAF.

Changes to the REIT regime

The Finance Act 2022 relaxed a number of conditions in relation to real estate investment trusts ("**REITs**") making them more accessible for GPs and investors. The changes aim to alleviate certain constraints and administrative burdens to enhance the attractiveness of the UK REIT regime for real estate investment.

The key changes are:

- The requirement for REIT shares to be admitted to trading on a recognised stock exchange has been removed

[3] https://www.bakermckenzie.com/en/insight/publications/2022/02/tax-risk-reshaped

where one or more "institutional investors" hold at least 70% of the REIT's ordinary share capital;

- The tax charge faced by REITs on the payment of property income distributions ("**PIDs**") to "holders of excessive rights" (*i.e.* corporate entities who hold at least a 10% interest in the REIT but excluding persons to whom a PID may be made without UK REIT withholding tax) no longer applies to PIDs paid to investors who are entitled to gross payment.

Developments in the cryptoassets space

In April 2022, as part of its FinTech Sector Strategy, HM Treasury announced a package of UK tax and regulatory measures affecting cryptoassets. One of those measures will be to expand the investment manager's exemption ("**IME**") to provide that certain types of cryptoassets would fall within the exemption. This means that existing UK GPs will be able to add to their managed portfolios and advise on cryptoassets from the UK without creating a risk of UK taxation.

On an international level, reform is also underway by the OECD to develop a new global tax transparency framework which provides for the automatic exchange of tax information on cryptoassets. A public consultation meeting on this is expected to be held at the end of May 2022.

Update on UK transfer pricing audit activity

Transfer pricing enquiries and Profit Diversion Compliance Facility ("**PDCF**") activity continue to pre-occupy many multinationals in the alternative asset management space. This is because HMRC has shown an interest in the area for some years now, supplementing the traditional enquiry-letter requests with the more recent PDCF procedures (where selected taxpayers are invited to re-examine their international tax, mostly transfer pricing, affairs and address any high-risk positions taken).

The marked difference of these recent enquiries and PDCFs is HMRC's focus on an evidence-based approach in investigating the positions taken. Email correspondence, location and role of the decision makers, investment committees' meeting minutes, and forensic examination of taxable returns are now on HMRC's radar and subject to increased scrutiny. In particular, all issues involving sharing of profits with other jurisdictions, especially low-tax ones, can be targeted (for instance, management / performance fee splits, cost allocations from head office to subsidiaries, transfer pricing of new products and platforms).

Having robust transfer pricing documentation to defend a transfer pricing position during an enquiry or PDCF is a good starting point but this would need to be supplemented by evidence gathering (preferably contemporaneously to the intercompany transactions taking place), a well-thought response strategy, negotiation skills and tactics in order to achieve a satisfactory outcome.

Matt Legg
Partner
matt.legg@bakermckenzie.com

Stephanie Pantelidaki
Partner
stephanie.pantelidaki@bakermckenzie.com

Tom Aston
Consultant
tom.aston@bakermckenzie.com

Vadim Romanoff
Senior Associate
vadim.romanoff@bakermckenzie.com

Alex Genov
Associate
aleksandar.genov@bakermckenzie.com