Baker McKenzie.

Newsletter

April 2023

Funds Tax Bites

Private Equity and Investment Funds Tax Newsletter

Welcome to our April 2023 edition of the Funds Tax Bites, where we provide a "bite size" overview of the key recent and anticipated tax developments globally that we expect to be of interest to those operating in the investment funds industry.

What's new?

The United Kingdom

1. **New carried interest election for managers with non-UK tax liabilities**: The Spring Finance Bill, which was published on 23 March 2023, includes an election that UK resident investment managers can make to accelerate their UK tax liability relating to carried interest. The purpose of the election is to be able to claim double tax relief in another jurisdiction for UK tax on carried interest. The election could be of interest to those UK tax resident carried interest holders that have to file US tax returns because the US tax on carried interest can be due earlier than in the UK and credit for the UK tax can be unavailable in the US.

2. **Basis period reform**: The UK tax authority has been consulting on changing the way sole traders and partners in partnerships report profits and losses arising from their business. The current basis period rules mean that tax is paid based on the financial performance of the business in the 12-month accounting period that ends in the tax year. However, under the rules with effect from 6 April 2023, and subject to transitional arrangements, the profit and loss will be apportioned and taxed between the start and end of the tax year, regardless of the year-end that the business prepares its accounts to. Therefore, if a business prepares accounts for the 12 months ending 31 December, it will have to apportion profits from two accounting periods to fit into the 6 April to 5 April timeline. For any traders whose accounting periods are not aligned with the tax year, there are transitional rules for 2023/24, which provide that trading profits in 2023/24 will be based on the period from the end of the 2022/23 basis period to 5 April 2024, thereby creating cash-flow issues (although it may be possible to spread profits equally over five tax years). These new rules will not apply to self-employed individuals and partnerships that prepare their accounts to 31 March or 5 April, and so it may be worth considering whether changing the business' accounting year-end to 31 March or 6 April could be beneficial.

3. **Reform of partnerships**: As part of the wider reform to improve transparency over UK companies and other legal entities, the UK government has been consulting on and is introducing reforms that will tackle the perceived abuse of English and Scottish limited partnerships and bring the legislation (some of which is over 100 years old) up to date. In addition to tightening registration requirements and increasing transparency requirements (e.g., requiring more detailed information about partners and the general nature of partnership business), it is anticipated that there will be a requirement for limited partnerships to maintain an "appropriate address" in the UK at which a person acting on behalf of the limited partnership can receive correspondence and a registered email address. When introduced (which is expected to be later in 2023), the new legislation will apply to both new and existing limited partnerships so it will be important to review existing structures and make sure they comply with the new requirements.

4. **VAT on fund management fees**: The government continues to consult on the VAT treatment of fund management services. The primary aim of the consultation is to codify the existing rules (some of which derive from EU law) but zero-rating for fund management services has been ruled out.

5. **UK-Luxembourg double taxation treaty**: The revised double taxation treaty between the UK and Luxembourg will take effect from 2024 at the earliest. As anticipated, the revised treaty will allocate the taxing rights to the UK where Luxembourg investors realize any capital gain on the disposal of a UK real estate-rich entity (including any gains arising before the changes take effect).

6. **UK REITs**: Certain aspects of the REIT rules have been relaxed with effect from 1 April 2023. In particular, there is now no requirement for a REIT to own at least three properties if it holds a commercial property worth at least GBP 20 million.

7. **UK investment manager exemption**: HMRC has recently confirmed that the list of "investment transactions" that benefit from the investment management exemption will be expanded to include "cryptoassets" (defined by reference to the OECD's Crypto-Asset Reporting Framework). HMRC confirmed that these changes will come into force with effect in relation to transactions

entered into during the 2022 to 2023 tax year (for non-corporate entities) and accounting periods current on 31 December 2022 (for corporate entities).

8. **UK sovereign immunity consultation**: HM Treasury has announced that it will not be proceeding with its proposed reform of the UK's sovereign immunity rules. As such, the existing (uncodified) rules will continue to operate as they do now.

9. **The UK mandatory disclosure rules**: The UK introduced new rules, with effect from 28 March 2023, which replace the existing (and narrow) mandatory reporting rules under the EU's "DAC6" rules. Broadly, the new rules require an intermediary (that is incorporated, resident or has a place of management in the UK) to make a report to HMRC with respect to an arrangement that is designed to circumvent common reporting standard rules or, alternatively, the identity of a beneficial owner of an offshore structure. Any reportable arrangements that are made available by intermediaries or implemented by taxpayers after 28 March 2023 will need to be reported within 30 days of this happening. Pre-existing arrangements will need to be reported within 180 days after the rules are implemented (i.e., by 25 September 2023).

10. **By way of reminder…** The new UK qualifying asset holding company (QAHC) regime (which is constantly being "improved" by the government by enabling a wider range of entities to own QAHCs and to make it possible for QAHCs to hold listed securities) has been in force since April 2022 and more than 120 fund managers have registered their own QAHCs to date. We continue to receive queries from fund managers about how the regime can benefit their structures and we expect that there will be more QAHCs as managers raise next rounds of investment and become more familiar with the conditions required to qualify for the regime. In our experience, there has been strong interest in the new regime from those fund managers operating credit strategies, but all managers that have a UK presence should consider introducing a QAHC into their structures.

Spain

1. **Carried interest taxation**: The Spanish government has recently announced the first ever set of rules governing the taxation of carried interest in Spain. These draft rules, which have been enacted with effect from 1 January 2023, provide that income from carry shares realized by managers will be treated as employment income subject to the Spanish personal income tax at progressive rates. However, there will be a 50% exemption that would apply on the income if a number of conditions are met, including a five-year holding period and that income arises from an eligible private equity fund. The 50% exemption means that carried interest will be taxed at a maximum rate of 22.75%-26.75% versus the standard rate of 45.5%-53.5%, which is a substantial saving. It is interesting to note is that these tax incentives have been approved simultaneously with a tax package applying higher taxes to the wealthy and the financial sector.

Italy

1. **PE investment management exemption**: The Italian 2023 Budget Law introduced a significant amendment to the definition of permanent establishment. This new provision became effective as of 1 January 2023 and aims to provide certainty for the asset management sector by clarifying the conditions that need to be satisfied to ensure that Italian investment managers do not constitute a permanent establishment of a non-Italian investment vehicle. Specifically, the amendment to the legislation provides that an Italian (or foreign) tax resident asset/ investment manager operating in Italy will not constitute a permanent establishment of the non-Italian investment vehicle if a number of conditions are satisfied (including that the foreign investment vehicle and its subsidiaries are resident in white-listed jurisdictions, the foreign investment vehicle operates at arm's length vis-à-vis the manager, the manager is not a member of the foreign investment vehicle's (and its subsidiaries') administration and control bodies, and the manager is not entitled to more than 25% of the profits of the foreign investment vehicle).

The practice corner: Proposed ATAD 3 Directive

As discussed in our January 2022 edition, on 22 December 2021 the EU Commission published a proposal for a Directive, "laying down rules to prevent the misuse of shell entities for improper tax purposes," referred to as the ATAD 3 Directive.

The proposed ATAD 3 Directive provides that "shell entities" are undertakings (in whichever legal form) that are engaged in a cross-border activity, more than 75% of their revenues are passive income and administration of day-to-day operations is outsourced. In line with the proposal, the "shell entities" would have to provide, alongside their annual tax returns, a declaration that they satisfy the minimum substance requirements, namely that they have their own premises, a bank account and qualified local directors or employees.

In January 2023, the European Parliament issued an amended, non-binding, version of the Directive ("**EP Version**"). On the one hand, certain aspects of the EP Version appear to impose stricter requirements on the undertakings, e.g., by deleting the exclusion for entities with "five own full-time equivalent employees." On the other hand, there are clear signs of a more balanced approach, e.g., by including a provision that would allow entities to outsource certain functions within the group and by loosening substance requirements relating to directors, who would be allowed to accumulate board mandates with third-party entities.

Negotiations are currently ongoing at EU Council level. Under the current Swedish presidency, there has been some progress and compromise texts were submitted to the other EU member states regarding parts of the ATAD 3 Directive (a version of the compromise text was leaked ("**Compromise Version**")). The Compromise Version is generally less friendly for the taxpayer as it significantly reduces the number of excluded entities and introduces a limitation on the number of mandates (up to four) that directors could have in other non-associated entities. There are, however, positive developments such as shared premises with other associated enterprises being relevant for the minimum substance requirements (as also suggested in the EP Version).

Further changes to the ATAD 3 Directive are expected and significant uncertainty remains regarding the final form of the ATAD 3 Directive as the EU Council requires unanimous approval by all 27 EU member states to adopt the final text.

Although it should be possible to navigate the substance requirements, as set out in both the EP Version and the Compromise Version, careful consideration should be given as to whether and how ATAD 3 could impact intermediate and subsidiary legal entities typically involved in international fund structures. In particular, fund managers should investigate (i) the planning strategies in case the exclusion for regulated (and lightly regulated) funds does not extend to intermediate entities through which a fund holds its assets, (ii) whether their intragroup outsourcing or group shared resources and infrastructure can be harmful or (iii) which conditions may need to be tested prior to the entry into force of the rules (two-year look-back period).

Timing for the council's vote is not yet known, although the current text (both in the EP Version and the Compromise Version) maintains that the ATAD 3 Directive would take effect from 1 January 2024. The adoption of the final text could slip into the Spanish presidency in the second half of 2023, if not later, which would delay the effective date of the directive.

For completeness, the measures announced by the EU to tackle shell entities located outside the EU have not yet been released.

Updates from Baker McKenzie

Listen to our Funds Tax Talks podcast series for a discussion and insights on some of the most pressing tax issues affecting investment funds.

Episode 3: Comparing the UK and Luxembourg as fund holding company platforms

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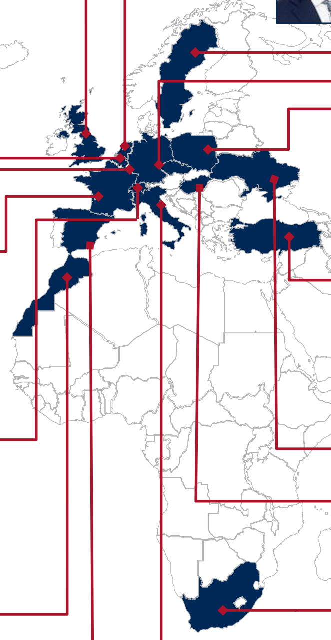

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