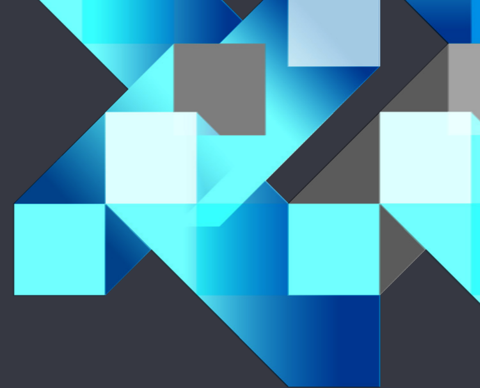

Schulte Roth&Zabel

Private Funds Tax Update for UK Managers

April 2021

- ## Proposals for a UK Asset Holding Company Regime

  The UK government's consultation on the possibility of introducing a new UK asset holding company regime, which would make it tax efficient for non-UK funds to use a UK investment subsidiary to hold investments, has recently concluded.

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- ## Offshore Fund Investments in UK Real Estate

  The United Kingdom's rules for the taxation of gains realised by non-UK residents when disposing of interests in UK real estate created the possibility of an unintended tax charge for non-UK funds that are not primarily real estate funds. The government will now issue regulations to address this and exempt such funds from the tax charge in most cases.

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- ## Changes to the UK's Anti-Hybrid Regime

  The United Kingdom's regime for the prevention of tax mismatches arising from hybridity — of entities or instruments — has contained anomalies and unintended consequences ever since its introduction. The rules will now be revised retrospectively in a way that should mitigate some of these adverse outcomes, particularly for US managers that have established sub-adviser entities in the United Kingdom.

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- ## A Brexit Dividend — UK Substantially Restricts DAC6 Reporting Obligations

  In an unexpected development, the government has announced that, following the United Kingdom's exit from the EU, the United Kingdom will implement the EU DAC6 tax information reporting regime for taxpayers and intermediaries in such a way that cross-border transactions will be reportable only in very exceptional cases.

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Proposals for a UK Asset Holding Company Regime

On 25 February 2021, the UK government's second stage consultation on a new tax regime for a UK asset holding company ("UK AHC") finished. The government's objective is to establish a regime for a UK AHC that can be used as an intermediate asset-holding entity in private fund structures (e.g., private equity funds, credit funds and real estate funds) and that will provide a credible UK equivalent to AHCs in other jurisdictions, such as the Irish section 110 company and the Luxembourg S.a.r.l. However, it remains a guiding principle of the government's approach that the use of a UK AHC should not confer any UK tax advantages over direct investment — investors (whether UK or non-UK) should be in roughly the same tax position when investing via a UK AHC as they would be in if they had held the relevant investments directly.

The second stage consultation identified and sought solutions for a number of key obstacles that had been identified to the establishment of a usable and attractive regime for a UK AHC. One significant problem that the government has posed for itself is the attempt to create a UK AHC regime that will facilitate a UK AHC holding investments across a wide variety of asset classes. The current proposals envisage that the UK AHC might be used in the contexts of private equity, securitization, real estate and private or alternative credit. The creation of a UK AHC regime that will enable a UK AHC to be a suitable vehicle in all these different settings — particularly real estate investing — but which does not create opportunities for unacceptable tax avoidance gives rise to a number of specific challenges:

1. *Capital Gains and Investor Taxation*. The government's current proposals are for a broad participation exemption for capital gains at the level of the UK AHC itself. However, the second stage consultation proposes adding a 'tracing' methodology, so that investors are treated as having themselves realised their respective shares of capital gains of the UK AHC (and taxed on those attributed capital gains according to their particular UK tax status). This gives rise to difficult issues where non-UK resident investors invest in a UK AHC which realises capital gains from disposals of direct or indirect interests in both UK land and non-UK land. It is far from clear how a UK AHC regime could achieve the "right" result of taxing non-UK resident investors on their share of UK AHC gains from disposals of interests in UK land, but not on their share of UK AHC gains from disposals of interests in non-UK land.

2. *Withholding Taxes*. AHCs in other jurisdictions — such as Ireland and Luxembourg — are typically funded by some form of profit-participating debt, in order to enable a tax-efficient means of profit extraction. These jurisdictions do not impose withholding tax on interest payments on this debt funding. The United Kingdom, by contrast, imposes a 20% withholding tax on interest on unlisted debt in many cases. A useable UK AHC regime will therefore need to provide an exemption from UK withholding tax on interest, particularly given that a UK AHC is likely to be utilised by funds or other widely held collective investment vehicles which are unlikely to be able to take advantage of double tax treaties with the United Kingdom to eliminate or mitigate the UK withholding tax.

3. *Value Added Tax*. Without the benefit of special rules, a UK AHC would be subject to UK VAT on its management fees. By contrast, management fees for AHCs in competitor jurisdictions such as Luxembourg and Ireland are generally exempt from VAT. Solving this VAT issue is therefore a key requirement before the United Kingdom can introduce a useable and effective UK AHC regime. However, current indications are not encouraging, as the government has announced that the question of VAT charged to a UK AHC will be considered as part of the United Kingdom's ongoing wider funds review.

The government originally intended to include legislation for the introduction of a UK AHC in Finance Bill 2021. However, it would seem that the difficulties of introducing an effective and attractive UK AHC regime

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at the same time as addressing the government's long-standing concerns over tax avoidance, erosion of the tax base and preservation of revenues in a time of economic downturn are proving difficult to overcome and no draft legislation has yet been published.

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Offshore Fund Investments in UK Real Estate

The regime[1] for the taxation of capital gains of non-residents disposing of interests in UK land or "UK property rich" entities introduced in 2019 imposed a UK tax charge on offshore funds making investments in UK real estate funds (such as UK REITs). In a welcome development, the government has now announced that it will legislate to change this, with retrospective effect, so that an offshore fund holding a less than 10% interest in a UK real estate fund will generally not be subject to UK tax on capital gains realised on disposals of such interests.

Currently, an offshore fund disposing of an interest in entity fund or collective investment vehicle ("CIV") that is "UK property rich"[2] — which would include UK real estate funds, such as a UK REIT — is liable to UK tax on capital gains on the realisation of that interest. This charge applies irrespective of the size of the offshore fund's interest in the "UK property rich" CIV and so significantly disincentivises offshore funds from making investments in "UK property rich" CIVs.

The government has now published for consultation[3] draft regulations which provide that an offshore CIV will not be liable to UK tax on capital gains realised on disposals of less than 10% interests in "UK property rich" CIVs, provided that the offshore fund:

- Is widely-held[4];
- Is not itself "UK property rich"; and
- Expects (and declares in its offering document) that not more than 40% of the market value of its assets will be made up of interests in UK land or "UK property rich" entities.

This change will be a welcome development for offshore funds that wish to have some part of their portfolio (40% or less) made up of minority interests in UK REITs or other "UK property rich" CIVs. Following the introduction of the new regulations (with their retrospective effect), capital gains realised on the disposal of such interests will not be subject to UK tax.

[1] Introduced with effect from 6 April 2019.

[2] An entity is "UK property rich" if 75% or more of the market value of its assets is derived from interests in UK land.

[3] It is expected that the regulations will be introduced in a form substantially similar to the draft version.

[4] This condition will be met if the offshore fund either meets a "genuine diversity of ownership" test, which broadly requires interests in the offshore fund to be made available to investors generally and not restricted to a narrow class of related investors, or a "non-close" test, which requires that it not be the case that 50% or more of the ownership interests in the offshore fund are held by five or fewer investors (with connected investors counting as a single investor for these purposes).

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Changes to the UK's Anti-Hybrid Regime

HMRC has now closed its second consultation on draft legislation proposing changes to the United Kingdom's "hybrid and other mismatches" rules. The draft legislation generally makes welcome changes to the United Kingdom's anti-hybrids regime, and these changes will be, in most cases, retrospective to the commencement of the regime on 1 January 2017.

The United Kingdom's anti-hybrids regime implements Action Point 2 of the OECD's BEPS report and is aimed at denying UK taxpayers tax advantages from "tax mismatches" that arise from arrangements involving hybrid entities (where the same entity is regarded as a "tax-transparent" or "flow-through" entity by one jurisdiction, but as a "tax-opaque" or "blocker" entity by another jurisdiction) or hybrid instruments (where the same financial instrument is regarded as debt for purposes of one jurisdiction but as equity by another jurisdiction). Other OECD jurisdictions either have implemented or are in the process of implementing their own hybrid mismatch rules. In particular, EU Member States were required to introduce hybrid mismatch rules from 1 January 2020 by the Anti-Tax Avoidance Directive (ATAD).

As an example, a common form of hybrid tax mismatch is the "deduction/non-inclusion mismatch" where the interposition of a hybrid entity as recipient of a payment means that a payment which is deductible for UK tax purposes is not included as taxable income in another jurisdiction. In these circumstances, the United Kingdom, under its anti-hybrid rules, would apply a "counteraction" to the payment, denying the payer a tax deduction for the payment to the extent of the "non-inclusion".

The draft legislation proposes changes in three key areas that are relevant to funds and alternatives managers:

1. HMRC implicitly concedes that the current "acting together" rules are too broad and can result in lenders and borrowers that are genuine third parties being regarded as in a control relationship (and so being brought within the scope of the hybrid mismatch rules where the lender is a hybrid). This has been a particular issue where a hybrid lender is a party to inter-creditor arrangements or where a lending transaction is combined with or has some element of equity participation. Under the proposals, the "acting together" test will be disapplied where the hybrid party itself has only a 5% or less equity interest (by votes or economic entitlement) of its own in the payer entity.

2. The draft legislation creates a new category of "inclusion/non-deduction" income — which will replace the current concept of section 259ID income — in order to prevent there being a counteraction to deny a deduction where the amount for which a deduction is claimed by a UK hybrid entity is matched by an amount which is included as income by the UK hybrid entity but for which the payer of that income has no deduction. This has been a particular issue for US managers with a UK affiliate which they fund through a sub-advisory fee. Where the UK sub-manager checks-the-box to be treated as a disregarded entity for US tax purposes (which has the effect of making it a hybrid entity for purposes of the UK's anti-hybrid rules), so that the UK's sub-manager's expenses are deductible for both US and UK tax purposes, this creates a double deduction that would in principle be subject to a counteraction in the United Kingdom. However, under the proposed changes, the sub-advisory fee should be treated as "inclusion/non-deduction" income — it is included as income by the UK sub-manager, but there is no deduction for the payment for the US manager. Accordingly, the double deduction can be matched with the inclusion/non-deduction income and so there should be no counteraction.

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3. The rules governing deduction/non-inclusion mismatches will be amended so that a deduction/non-inclusion mismatch will not be treated as arising where the investor in the hybrid entity is in a category of tax-exempt "qualifying institutional investors" (broadly pension funds, life assurance schemes, charities and sovereign wealth funds). The broad aim of the changes is to ensure that there is no counteraction for a deduction/non-inclusion mismatch where a payment would not have been included as taxable income — because of the tax-exempt status of the investor — even if the direct recipient of the payment had not been a hybrid entity.

Once these retrospective changes have been introduced by Finance Act 2021, funds and managers should examine the structure of their management group to determine whether any changes are appropriate. Because of the retrospective nature of some of the changes, it may also be possible in some cases to revisit existing structures and to recover any tax leakage suffered as a consequence of the application of the (now amended) anti-hybrid rules.

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A Brexit Dividend — UK Substantially Restricts DAC6 Reporting Obligations

On 29 December 2020, the United Kingdom, in an unexpected but very welcome development, introduced amending regulations that will largely remove any obligation for UK asset managers to comply with the EU's DAC6 mandatory disclosure regime.

DAC6 is an EU Directive that requires "intermediaries" — such as asset managers — and taxpayers to disclose to their local tax authorities arrangements they are involved in which display one or more specified "hallmarks". The primary obligation to report falls on the intermediary, but if the intermediary does not report for some reason (for example, the intermediary is a law firm that cannot be required to report because of legal professional privilege), the reporting obligation falls back on to the taxpayer. For example, an asset manager in an EU Member State advising a fund in relation to a transaction that displays a DAC6 hallmark is an intermediary of the taxpayer fund and therefore must disclose details of the transaction to its local tax authority. If the asset manager failed to report, the taxpayer fund would then have a secondary reporting obligation. Although intended to enable tax authorities to identify "tax avoidance" transactions, some of the hallmarks are widely drawn, and so DAC6 may require disclosure of a number of common commercial transactions. The first DAC6 reporting deadline fell on 31 January 2021, for disclosure of all reportable arrangements where the reporting trigger occurred in the period 25 June 2018 to 31 December 2020.

Previously, the United Kingdom had announced that, despite Brexit, it would implement DAC6 in full in the United Kingdom. Now, however, in a surprise development, the United Kingdom will only require disclosure of arrangements that display one of the 'Category D' hallmarks — either an arrangement that may have the effect of undermining reporting obligations under the OECD Common Reporting Standard (CRS) or an arrangement that is structured in such a way that beneficial owners cannot be identified. This is a very significant limitation on the scope of the obligation — the Category D hallmarks are only two of 19 DAC6 hallmarks in total and are very unlikely to arise in practice — and as a result DAC6 should broadly cease to be applicable to UK asset managers. HMRC has also indicated that, following the decision only to implement DAC6 to this very limited extent, it will soon bring forth legislation to replace DAC6 reporting obligations with the reporting obligations required by the OECD's Mandatory Disclosure Regime (which would again only require disclosure of arrangements with hallmarks broadly similar to the two Category D hallmarks).

The removal of DAC6 disclosure obligations from UK intermediaries such as UK asset managers is clearly good news. However, UK managers managing EU funds or with subsidiaries or operations in EU Member States need to recognise that (now that there are no UK DAC6 reporting obligations), where the fund enters into arrangements that display a DAC6 hallmark, DAC6 reporting obligations will fall on the fund itself or on a management subsidiary in an EU Member State. For larger management groups with operations in other EU jurisdictions, or for UK managers managing EU-based funds, this is likely to mean that DAC6 compliance has not gone away. The UK manager may still have to take a leadership role in DAC6 analysis and in ensuring that appropriate DAC6 reports are made in the relevant EU jurisdictions, whether that is by the (taxpayer) EU fund or its own management subsidiaries.

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