TRAVERS SMITH

Asset Management Tax: Summer reading

JULY 2017

Introduction

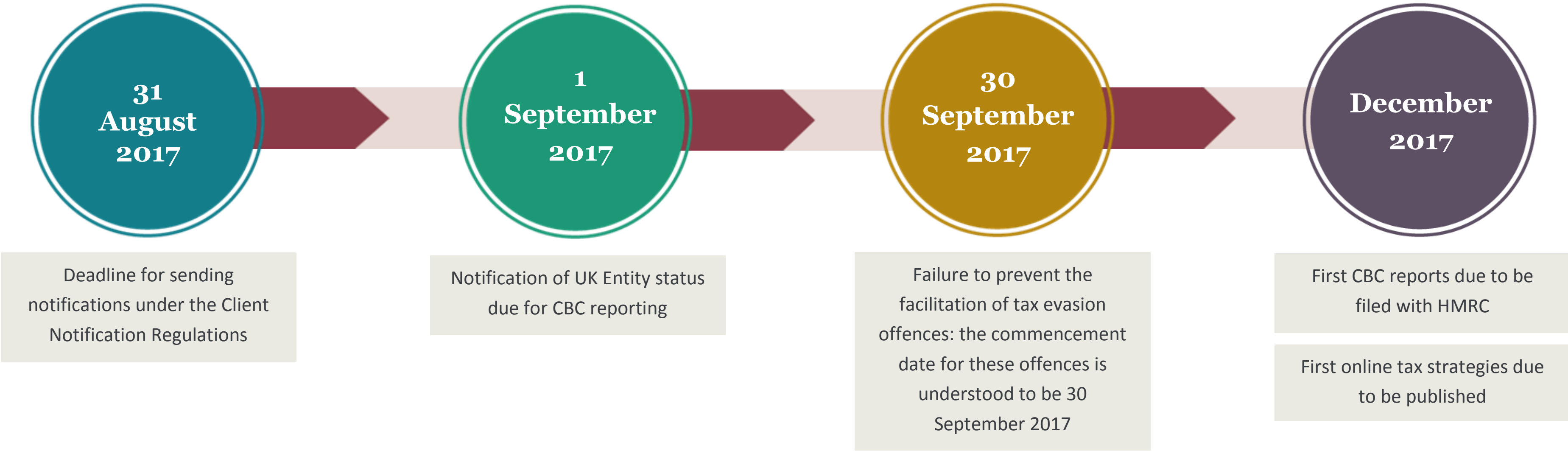
We thought that an update on asset management tax was due, not least because there are a number of key compliance deadlines coming up (dull, but they cannot be ignored).

We also wanted to brief you on the OECD's multi-lateral instrument ('MLI'). Over 70 jurisdictions signed up to this on 7 June 2017 and working through the amendments made by each jurisdiction to their treaties is a big job. We have focused on the treaty changes most relevant to funds and asset managers (treaty abuse and PE status) to give you an overview of the options chosen by key jurisdictions.

A further briefing will follow shortly once the Summer Finance Bill is published, showing what is in (and what has been abandoned or postponed) following the general election.

If you need guidance on any of these matters, please do get in touch. Our contact details are at the end.

Compliance – upcoming deadlines



Client Notification Regulations

These rules require certain financial institutions to send a notification to some or all of their UK resident individual accounts holders by **31 August this year**. This is a one-off mailing: it is not an annual requirement.

The rules tie in with the existing CRS (common reporting standard) framework and the definitions used in the CRS rules – "financial institutions", "accounts" and "maintaining an account" - all apply here. As under the CRS, financial institutions include banks, building societies, insurers, fund managers, investment funds, wealth managers and certain trusts. However non-reporting financial institutions under the CRS and organisations with charitable or other non-profit purposes are excluded from these obligations (even if they are a financial institution under the CRS).

The notification tells the individuals about HMRC's worldwide disclosure facility, and must be given in a prescribed form attaching HMRC's factsheet.

The rules also extend to non-UK financial institutions if they are controlled by, or branches of, UK financial institutions.

What should asset managers and investment funds be doing now?

The deadline for sending notifications is **31 August 2017**.

Investment funds and fund managers are likely to be CRS financial institutions. However, funds and fund managers will need some advice on whether the rules apply to them because their practical application is very fact-dependent. The rules have the potential to have extra-territorial reach, i.e. to apply to non-UK funds in some circumstances. If the rules do apply, then the fund will need to identify whether it had UK resident 'account holders' (debt or equity investors in the fund) at 30 September 2016.

Funds which are in-scope must then choose whether to send HMRC's notification and factsheet to:

- All UK resident individuals whose 'account' (i.e. their interest in the fund) is in a CRS participating jurisdiction or the US; or
- All UK resident individuals with high-value accounts (where the value exceeds €1m).

A penalty of £3,000 may be imposed for a failure to comply.

Failure to prevent offences

New rules were introduced in the Criminal Finances Act 2017 which can result in a company, partnership or LLP being itself criminally liable if a person who performs services for or on behalf of the business criminally facilitates another person's tax evasion. The business has a defence to the new crime only if it can show that it has implemented reasonable "prevention procedures".

A company/partnership found guilty of this offence could be liable for unlimited financial penalties, confiscation orders or serious crime prevention orders. A criminal conviction could be disclosable to the regulator and could have adverse consequences on an asset manager's (or fund's) regulatory status.

What should asset managers and investment funds be doing now?

This offence will impact all UK asset managers & advisers and their UK funds. Non-UK asset managers & advisers and non-UK funds are also potentially caught if UK tax is evaded or there is another UK nexus (for example, if some of the 'aiding and abetting' takes place in the UK).

HMRC expects businesses to have conducted a risk assessment by **30 September 2017**, and be **in the process** of implementing an action plan to update compliance policies and procedures, including business-wide training, supply-chain due diligence and internal communication, supervision and whistle-blowing mechanisms.

Becoming compliant will involve significant tax, legal & compliance team involvement, so begin thinking about this offence now, if you have not already.

Country-by-country reporting

Country-by-country reporting is **already in force** for MNE (multi-national enterprise) groups. It is an annual reporting requirement for groups with **consolidated group revenues for an accounting period of €750m or more**.

CBCr requires the following reports to be filed with HMRC:

1) **Annual country-by-country report** – due within 12 months from the end of the reporting accounting period. The first reporting accounting period began on 1 Jan 2016 and so the first reports will be due at the end of 2017.

2) Annual notification of:
   - **UK Ultimate Parent Entity ('UPE') status** – a UK UPE must identify itself to HMRC and identify any UK 'Constituent Entities' in its group, if any. A UK 'Constituent Entity' is an entity which is: resident in the UK, has a PE in the UK or is a UK LLP, LP or partnership.
   - **UK Constituent Entity status** – if the ultimate parent is not in the UK, then UK Constituent Entities below the ultimate parent must identify themselves to HMRC.

What should asset managers and investment funds be doing now?

Fund and asset managers should already have determined, with assistance from their auditors, whether their asset management group and/or the funds they manage are inside or outside the scope of country-by-country reporting for the 2016 reporting accounting period – the **first reports** are due to be filed with HMRC from **31 December 2017**. Country-by-country reporting is an annual requirement, so the revenue threshold should continue to be monitored going forward.

The annual notification of entity status must be provided to HMRC at the **end of each reporting accounting period**. However, for reporting periods ending before 1 September 2017, the deadline is **1 September 2017**.

Large business tax strategy

The UK's large business tax compliance rules require businesses over a certain size, including partnerships, to publish a tax strategy on the internet before the end of the business' financial year (for accounting periods commencing after 15 September 2016).

For example, UK partnerships (e.g. UK private equity, PERE and/or credit funds structured as limited partnerships) will be caught if their turnover in the previous financial year was more than £200 million, or their balance sheet exceeded £2 billion.

What should asset managers and investment funds be doing now?

Funds and fund managers should have already concluded whether their asset management business and/or the funds they manage are within scope.

In-scope managers and funds should have started to think about what their strategies should look like. When the first strategies are published towards the end of 2017, there may be considerable media interest.

BEPS and the Multilateral Instrument

What is the OECD's Multilateral Instrument ("MLI") and how is it relevant to asset managers and investment funds?

The MLI is a key tool in the implementation of BEPS (base erosion and profit shifting). Last month, in Paris, 76 jurisdictions signed up to the MLI, with the potential to amend over 2,300 double tax treaties.

How does the MLI work?

A jurisdiction signs-up and indicates that it would like its double tax treaty with another jurisdiction to change. By way of example, Luxembourg has indicated that it would like its treaties with the UK and the US to change.

The next thing to check is what the UK and the US want. The UK has signed-up to changing its treaty with Luxembourg, so it is now certain that the MLI will apply to it. The US has not signed the MLI, so Luxembourg's desire to change its tax treaty with the US has no effect.

Once you know that a treaty is going to change, the next question is "in what respect?" The MLI covers a wide range of BEPS-related points, but the two changes of most relevance to investment funds are: (1) the prevention of treaty abuse (inserting a "principal purpose test" and/or a "limitation on benefit" clause into treaties); and (2) changes to the definition of a permanent establishment.

Both jurisdictions have to sign up to the same change if it is to have effect. This won't always be the case. A number of the specific BEPS changes (including those relating to the definition of a permanent establishment) are not mandatory: instead, OECD jurisdictions can "reserve" their position and not sign-up to those changes.

However, if both jurisdictions have signed up to the same change, then the treaty will be modified for that change once the MLI comes into force. That will happen three months after the first five jurisdictions ratify it under their domestic procedures. For each subsequent jurisdiction, the MLI will come into force three months after ratification.

Once both relevant jurisdictions have ratified the MLI, any changes will come into effect after a further period of time has elapsed (which depends on the type of tax). In practice, it is expected that the MLI will start to modify the first set of tax treaties in 2018.

Which treaties are covered by the MLI?

By way of example only, we have listed the treaties that will be, and will not be, modified by the MLI in the key holding company, asset management and fund jurisdictions.

	UK	Luxembourg	Ireland	Jersey	Guernsey	Germany	France	Netherlands	Italy	US	Hong Kong	Singapore	Australia
Treaty covered by MLI	Luxembourg Ireland Germany France Netherlands Italy Hong Kong Singapore Australia	UK Ireland Jersey Guernsey Germany France Netherlands Italy Hong Kong Singapore	UK Luxembourg Germany France Italy Hong Kong Singapore Australia	Luxembourg Hong Kong Singapore	Luxembourg Hong Kong Singapore	UK Luxembourg Ireland France Netherlands Italy	UK Luxembourg Ireland Germany Netherlands Italy Hong Kong Singapore Australia	UK Luxembourg Germany France Italy Hong Kong Singapore Australia	UK Luxembourg Ireland Germany France Netherlands Hong Kong Singapore Australia	None	UK Luxembourg Ireland Jersey Guernsey France Netherlands Italy	UK Luxembourg Ireland Jersey Guernsey France Netherlands Italy Australia	UK Ireland France Netherlands Italy Singapore
Treaty not covered by MLI	Jersey Guernsey US	US	Netherlands US Jersey* Guernsey*	UK Guernsey Germany* France* Australia* Ireland* US*	UK Jersey Australia* Ireland*	Jersey* US Hong Kong* Singapore Australia	Jersey* US	Ireland US	US	All – US has not signed	Germany* US* Singapore*	Germany US* Hong Kong*	Jersey* Guernsey* Germany US
No treaty		Australia		Netherlands Italy	Germany France Netherlands Italy US	Guernsey	Guernsey	Jersey Guernsey	Jersey Guernsey		Australia		Luxembourg Hong Kong

**These jurisdictions have partial tax treaties only*

The MLI and treaty abuse

If a jurisdiction has signed up to the MLI, then its treaties will change to include:

- the principal purpose test ('PPT') only (unless the treaty in question already has equivalent wording); or
- the PPT and a simplified limitation on benefits provision (LOB) (unless the treaty has equivalent wording); or
- a detailed LOB provision (but no PPT), with additional rules to address conduit financing structures.

The PPT says:

> *"... a benefit... shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement."*

	Treaties that will include a PPT		Treaties that will not include a PPT
UK	Luxembourg Ireland Germany France Netherlands	Italy Hong Kong Singapore Australia	Jersey Guernsey US
Lux	UK Ireland Jersey Guernsey Germany	France Netherlands Italy Hong Kong Singapore	US
Ireland	UK Luxembourg Germany France	Italy Hong Kong Singapore Australia	Netherlands US Jersey Guernsey

Example jurisdictions from table on page 6

Jurisdictions can opt into a provision which allows those who are denied treaty benefits under the PPT to appeal to the tax authorities to reinstate the benefits in certain circumstances.

MLI POSITIONS

All the jurisdictions in the table on page 6 (excluding the US) will either apply the PPT to their covered tax treaties or are satisfied that those treaties already contain equivalent PPT wording.

The UK has not notified any covered treaty which it thinks contains a PPT equivalent provision, so it will adopt the MLI PPT wording.

No jurisdiction in the table on page 6 (apart from the US, which already has a LOB in many of its treaties) has chosen to introduce a LOB.

WHAT SHOULD ASSET MANAGERS AND INVESTMENT FUNDS BE DOING NOW?

Funds should have a good sense of which entities in their structures are treaty-reliant, and the quantum of that reliance.

If a fund is heavily treaty-reliant, now is the time to consider whether this is robust post-BEPS. Footprint and functionality and investor identity may all play a part. It isn't just a numbers game but, if substance in terms of functionality and footprint are light, funds may want to consider their options for strengthening them and understanding the potential lead-time needed to do so.

They should also understand whether their structures have more than one layer of protection (for example, debt might also be structured as listed Eurobonds) and whether these additional safety nets may be vulnerable when the UK leaves the EU (for example, where the extra comfort comes from an EU directive such as the Parent-Subsidiary directive).

In short, where a fund vehicle is treaty-dependent, it will need to understand (probably by early 2018) whether it can still rely on that treaty.

The MLI and the definition of Permanent Establishment

There are three main changes to the definition of a permanent establishment that are relevant for investment funds and asset managers.

1. Agents

The OECD has proposed that the definition of a permanent establishment is extended to include agents which:

"*habitually play the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise*".

This is a potentially significant extension – most treaties currently classify agents as a permanent establishment only if they habitually exercise authority to conclude contracts, i.e. actually execute the contract. The amended wording has the potential to catch those playing key advisory roles too.

The model treaty has always included an exemption for agents which are 'independent'. This exemption is now narrowing to exclude those agents which act exclusively or almost exclusively for "closely-related" enterprises (broadly, 50% holdings).

MLI Positions

The changes described above do not represent an OECD minimum standard and so jurisdictions can choose not to make the modification.

The UK, Jersey, Guernsey and the majority of EU countries, including Ireland, Luxembourg, Italy and Germany have all chosen **not to apply these changes**. Outside the EU, Australia, Hong Kong and Singapore are examples of countries which will **also not apply these changes**.

Some EU countries, including France, the Netherlands, Spain and Croatia, have decided to include these changes. Outside of the EU, notable jurisdictions opting in include Japan, New Zealand, India and a number of Latin American jurisdictions.

What should asset managers and investment funds be doing now?

Fund managers' focus should be on their operations and vehicles in jurisdictions which have opted-in to these changes.

Whilst the primary holding company, asset management and fund jurisdictions (UK, Luxembourg, Ireland and the Channel Islands) have not opted into these changes, fund managers should have a strong sense of the roles played by their teams on the ground vs. the role played by the manager in 'opt in' countries. Operations and relationships between, for example, the Netherlands, France and Spain may need closer examination.

Fund managers in impacted jurisdictions should take local law advice (we can help with this). They should consider whether new decision-making protocols are needed and this may involve some internal training for teams. They should also understand what their fund documents (LPA and investor side letters) say about the degree of care a fund manager is required to take in order to ensure that it does not create a permanent establishment for its fund or investors in key jurisdictions.

2. The activity exemptions

There have always been exemptions in the OECD model treaty to ensure that certain activities do not constitute a permanent establishment (the 'activity exemptions'). The OECD is concerned that the activity exemptions can be used artificially to avoid creating a permanent establishment.

To tackle this, the MLI allows jurisdictions to choose one of three options, below. However this change does not represent an OECD minimum standard, so jurisdictions can choose not to make the modification.

Option A

This adds an overarching condition to the activity exemptions, so that each activity is only exempt if it is "preparatory or auxiliary".

Option B

This maintains the position that the specific activities constitute exemptions in themselves, irrespective of whether the activity is of a preparatory or auxiliary character. For jurisdictions with the OECD Model PE provision in their tax treaties, Option B will, in effect, maintain the current position.

Option C

No change - preserve existing tax treaty provisions.

- Option A was picked by around a third of countries, including Germany and the Netherlands.
- Option B was picked by France, Ireland and Luxembourg, amongst others.
- The UK chose to apply neither option – Option C.
- Jersey and Guernsey opted out of the application of all of these provisions.

3. Anti-fragmentation

Another avoidance technique which concerns the OECD is 'fragmentation': this is where a number of activities take place in a jurisdiction but they are artificially separated, so that no single activity is enough – by itself – to create a permanent establishment.

The MLI includes an anti-fragmentation provision. It provides that the activity exemptions do not apply if:

- an enterprise (or another closely-related enterprise) already has a place of business in that jurisdiction which constitutes a permanent establishment; or
- the overall combined activity carried on by the enterprise and its closely-related enterprises is not, when taken together, preparatory or auxiliary in nature.

MLI Positions

These changes do not represent an OECD minimum standard and so jurisdictions can choose not to make the modification.

The UK did opt-in to the **anti-fragmentation rule**, as did the majority of signatories. However, Germany and Luxembourg were amongst the jurisdictions that opted out of the anti-fragmentation rule.

Jersey and Guernsey opted out of the application of all of these provisions.

What should asset managers and investment funds be doing now?

Anti-fragmentation may be less relevant to fund management businesses, but asset managers may want to consider whether any of their portfolio companies operating cross-border should look again at their activities in certain jurisdictions to take a holistic view of whether they may now have a permanent establishment.

FOR FURTHER INFORMATION, PLEASE CONTACT

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