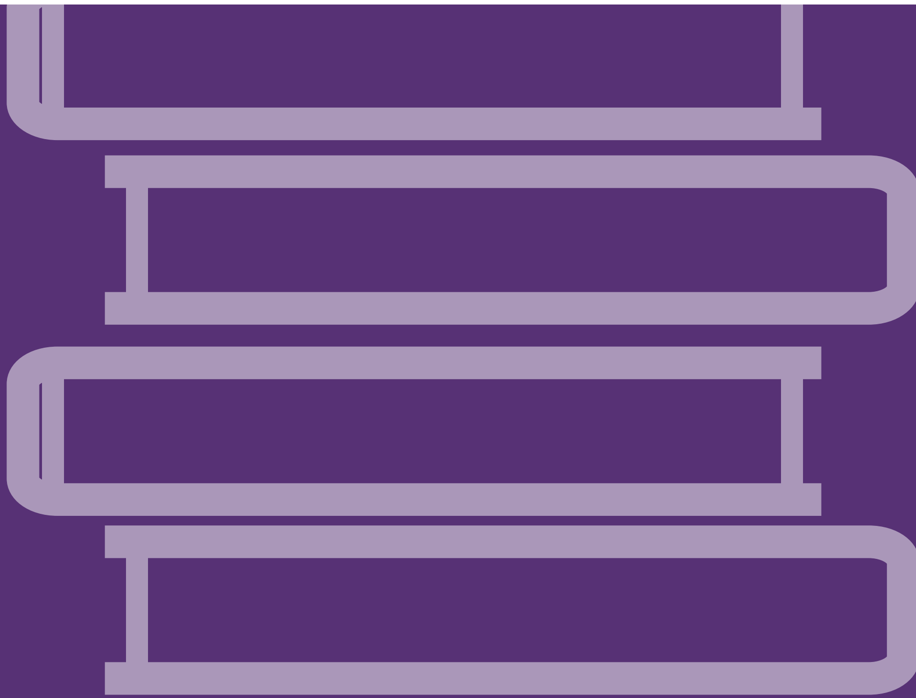
British Private Equity & Venture Capital Association



Technical Bulletin

Keeping you at the forefront of private equity and venture capital in the UK

November 2020

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Introduction

Welcome to the BVCA Technical Bulletin, a collection of in-depth articles by members of the BVCA and our three technical committees: Regulatory; Legal & Accounting; and Taxation. Our goal is to keep BVCA members informed of the key topics on the committees' agendas, how they impact the private equity and venture capital industry, and how the BVCA and committee members are engaging with policymakers and regulators. The Bulletin is published twice a year.

The Covid-19 pandemic has continued to impact the way we work, the businesses private equity and venture capital invest in and the outlook for the global economy. Following on from our detailed briefing in the May edition of this Bulletin, we provide an update on the BVCA's ongoing dialogue with government.

The Taxation Committee has responded to several consultations in recent months, many of which had been postponed following the outbreak of the pandemic. Mark Baldwin and Abigayil Chandra's article provides an overview of the committee's engagement on carried interest, specifically the Office of Tax Simplification's review of Capital Gains Tax, and the continuing engagement with HMRC on the guidance related to the carried interest and disguised investment management fee legislation. Another area of importance is the legislation regarding hybrid entities and the article from Russell Warren and James Pratt examines the recent consultation and guidance. Jonathan Page provides an update on the consultation on uncertain tax positions.

The tax section of the Bulletin concludes with Paul Eastham and Charlie Cartiglia's article on the EU Mandatory Disclosure rules (DAC6), where they provide an overview of recent European changes, UK guidance, and the questions firms should consider when making disclosures. The Taxation Committee continues to engage with domestic and global stakeholders, on areas including: the OECD's Digitalisation Programme; the European Parliament's work programme; and the HMT consultations on Asset Holding Companies and VAT Grouping.

Alongside regular dialogue with the FCA and HMT on a range of topics, including Brexit, Covid-19 and LIBOR transition, a key ongoing focus for the Regulatory Committee during the last six months has been the development of both EU and UK sustainable finance regulation, which affects firms with regulated entities in either jurisdiction, as well as their investors and portfolio companies. The EU has been particularly prolific in this area, and the Committee has helped respond to EU consultations on: extending the Non-financial Reporting Directive beyond listed companies; amending AIFMD and MiFID to incorporate the consideration of sustainability issues in firms' operations; refreshing the EU's sustainable finance strategy; and establishing detailed requirements under the EU's sustainability-related disclosure framework ("SFDR").

From a UK perspective, the Committee has responded to the FCA's proposals to introduce requirements for UK listed companies to report against the Recommendations of the G20's Taskforce on Climate-related Financial Disclosures ("TCFD"), which are likely to affect UK portfolio companies and regulated firms in due course. Tom Taylor's article takes a closer look at the latest position regarding the most directly and immediately applicable of these sustainability developments, namely the SFDR framework that applies in the EU from March 2021.

Another critical area of engagement for the Committee has been around the development of a new prudential framework for MiFID investment firms in the UK and EU. James Smethurst's article assesses the latest developments and highlights the key considerations for affected firms. The Regulatory Committee, alongside the Legal & Accounting Committee, is also heavily engaged in the European Commission's review of AIFMD and the BVCA's response to government consultations that could increase access to DC pension schemes for private equity and venture capital.

Amy Mahon
Chair, Legal & Accounting Committee

Mark Baldwin
Chair, Taxation Committee

Tim Lewis
Chair, Regulatory Committee

Gurpreet Manku
Deputy Director General, BVCA

The Legal & Accounting Committee has continued to support the BVCA's work in response to Covid-19, including new legislation covering insolvency and pensions. The Committee has been monitoring changes to foreign investment regimes in the EU and is in dialogue with the Government on the UK's regime, including the recent publication of the National Security and Investment Bill. The Committee is also continuing to review the impact of LIBOR transition on members' activities and working with BEIS on limited partnership reform.

In her article, Victoria Sigeti discusses the Government's proposals for corporate transparency and register reform, and the Committee's work in this area. Geoff Kittredge, with the assistance of Richard Lawton and John Young, provides a case law update, including cases related to Covid-19, as well as a new landmark case on asset-stripping. Please note that the Legal & Accounting Committee continues to publish monthly accounting and legal updates, which are available on the BVCA website.

Brexit update

The Government has committed to finalising the negotiations and agreement terms by the end the transition period on 31 December 2020, emphasising that it will not seek to extend the transition period beyond this date. Negotiations between the UK and the EU have resumed with Lord Frost and Michel Barnier committing to meeting daily to help finalise the deal. They agreed that "nothing is agreed" until progress has been reached in all areas, which has been a demand of the EU. Key areas to finalise include fishing rights, post-Brexit competition rules and how the deal would be enforced.

The BVCA has continued to monitor the progress of the UK-EU negotiations through our monthly Brexit Bulletin and we continue to provide representations to the FCA and HMT on the industry's priorities.

The UK has been the leading EU jurisdiction for wholesale asset management and for venture capital and private equity in particular for decades. This has partly been facilitated by the UK's regulatory regime and partly by the access which UK-based service providers have to EU investors and the ability of EU based firms to invest in the UK. In summary, we have stated that:

- The FCA and ESMA must publish as soon as possible the Multilateral Memorandum of Understanding that was agreed between the FCA, ESMA and Member State regulators.
- Well-functioning National Private Placement Regimes in the UK and EU Member States are essential to maintaining global capital flows and must be preserved.
- The current rules on delegation under AIFMD operate effectively and must not be made more restrictive (note that this is an area under consideration as part of the Commission's ongoing AIFMD review).
- The AIFMD third country passport regime, as currently drafted, is not appropriate for the UK PE/VC industry and we are not in favour of it being activated *following the end of the implementation period* as there are a number of practical challenges in this regime. There is still some interest in a *reformed* AIFMD third country passport *in the future*.
- Equivalence under MiFID is also important for our members.

Our committee members

The BVCA is immensely grateful for the time, enthusiasm and expertise of members of the technical committees as their work is crucial to our political engagement and advocacy activities. We would like to thank all members that have served on the technical committees, including those who have recently stepped down, for their considerable contributions.

	New members on our committees	Members who stepped down
Legal & Accounting Committee	**Benjamin Marten** (Bridgepoint) **James Douglas** (Linklaters) **Yasir Aziz** (Deloitte)	**Garrath Marshall** (Deloitte)
Taxation Committee	**Elaine Gwilt** (KPMG) **Jessica Haigh** (Permira)	**Dan Kennedy** (Permira) **Russell Gibson** (KPMG)

We would also like to extend our thanks to the excellent secretariat at the BVCA who support the work of our three committees so well.

If you have any questions, or would like to get more involved in the work of the committees and their working groups, please feel free to get in touch with any of us.

With best wishes,

Amy Mahon

Chair,
Legal & Accounting Committee

Mark Baldwin

Chair,
Taxation Committee

Tim Lewis

Chair,
Regulatory Committee

Gurpreet Manku

Deputy Director General, BVCA

Legal & Accounting Committee

Amy Mahon (Chair)	Simpson Thatcher
Alastair Richardson (vice-Chair)	3i
Angel Quek	Latham & Watkins
Ashley Coups	EY
Babett Carrier	Cinven
Benjamin Marten	Bridgepoint
Chris Bulger	Vitruvian Partners
Ed Hall	Goodwin Procter
Elizabeth Judd	STAR Capital
Geoffrey Kittredge	Debevoise
James Douglas	Linklaters
John Atherton	Ares Management
John Heard	Abingworth
Jonathan Martin	KPMG
Jonny Myers	Clifford Chance
Karen Sands	Hermes GPE
Nick Reid	Carlyle
Richard Mcguire	PwC
Steven Smith	Macquarie
Tom Alabaster	Ropes & Gray
Victoria Sigeti	Freshfields Bruckhaus Deringer
Yasir Aziz	Deloitte

Regulatory Committee

Tim Lewis (Chair)	Travers Smith
Rachel Thompson (Vice-Chair)	Bridgepoint
Andrew Lewis	ICG
Christopher Crozier	Permira
Ed Kingsbury	CMS
James Smethurst	Freshfields Bruckhaus Deringer
John Decesare	3i
John Morgan	Pantheon
Lindsay Hamilton	Livingbridge
Mark Howard	KKR
Matthew Cottrell	Carlyle
Neel Mehta	DWS Private Equity
Owen Lysak	Clifford Chance
Paul Cook	YFM Equity Partners
Paul Ellison	Macfarlanes
Peter Moore	Cinven
Simon Powell	Advent International
James Humphrey (Secondee)	Travers Smith

Taxation Committee

Mark Baldwin (Chair)	Macfarlanes
Abigayil Chandra (Personal Tax Sub-Committee Chair)	Deloitte
Clare Copeland (Corporate Tax Sub-Committee Chair)	Carlyle
Alexander Conway	Livingbridge
Alexander Cox	Ashurst
Alexandra Hone	ICG
Anthony Stewart	Clifford Chance
Caroline Conder	LDC
Craig Vickery	Exponent
Elaine Gwilt	KPMG
Eli Hillman	Grant Thornton
Gareth Miles	Slaughter & May
Garry O'Neill	3i
Graham Iversen	Greenberg Traurig
James Pratt	BDO
James Sanderson	Vitruvian Partners
Jenny Wheater	Debevoise
Jessica Haigh	Permira
Jill Hardie	Aberdeen Standard Investments
Jonathan Page	PwC
Jose Maria Palicio	Permira
Maria Carradice	Mayfair Equity Partners
Matthew Saronson	Debevoise
Michael McCotter	Charterhouse Capital Partners
Paul McCartney	EY
Richard Vitou	Deloitte
Russell Warren	Travers Smith
Stephen Pevsner	Proskauer
Tim Hughes	PwC
Tim Lowe	Kirkland & Ellis
Tony Mancini	KPMG
Rhiannon Kinghall Were (Secondee)	Macfarlanes

01.

BVCA response to Covid-19

Gurpreet Manku (BVCA)

01. BVCA response to Covid-19

Gurpreet Manku
Deputy Director General, BVCA

Nine months on from the outbreak of the Covid-19 pandemic in the UK and Europe, the industry has adapted seamlessly to working from home (with many offices opening up again over the summer in a Covid-compliant way), and Invest Europe's H1 2020 data shows that private equity and venture capital fundraising and deal activity has remained relatively resilient. Supporting portfolio companies and managing liquidity throughout the crisis has been a key priority for firms and the BVCA has continued to advocate for access to Covid-support measures such as the loan guarantee schemes. We have also participated in industry discussions with policymakers about the recovery, and the role of the private equity and venture capital industry in this.

In the May 2020 edition of the Technical Bulletin, we covered the BVCA's work as the pandemic unfolded, including on funding facilities such as the Coronavirus Business Interruption Loan Scheme ("CBILS"), the Coronavirus Large Business Interruption Loan Scheme ("CLBILS") and the Future Fund, as well as important regulatory, reporting, tax and legal matters. This article provides a short update on developments since May.

Government-backed funding schemes

Over the summer, the BVCA continued its discussions with HM Treasury and other stakeholders on private equity's access to the loan guarantee schemes. A number of PE/VC-backed businesses are technically considered to be an "undertaking in difficulty" under the definition being applied as part of the EU state aid rules (which the UK has to follow until the end of the year). However, the UK has implemented two changes which may have been helpful for some businesses:

- On 29 June, the European Commission adopted an amendment to the State Aid Temporary Framework disapplying the more problematic elements of the undertaking in difficulty definition for micro and small companies. The amendment aimed to benefit start-ups and small businesses in a high-growth, loss-making phase. On 30 July, HMT set out its expectation that these changes would be implemented to ensure more businesses received support under CBILS.
- In parallel, we worked closely with HMT as the Government continued to explore whether more clarifications could be provided on the undertaking in difficulty definition, and this work was highlighted in a ministerial letter to the lending community and UK Finance. The British Business Bank has announced more flexibility on the assessment date for the test of whether a business is an 'undertaking in difficulty' under EU state aid rules. This may pave the way for some portfolio companies to undergo restructurings or inject new equity that could allow them to access the CBILS or CLBILS.

The Future Fund continues to be popular and more funding has been made available for the scheme since its initial launch. The latest Treasury data shows that 874 loans had been approved totalling £875.8m.

CBILS, CLBILS and the Future Fund have been extended until 31 January 2021. The Chancellor has also referred to a new loan guarantee scheme next year and our dialogue with HMT and BEIS is continuing on this.

Updates to national security and investment legislation

The Government has amended the Enterprise Act 2002 to allow the Government to scrutinise certain foreign takeovers to ensure they do not threaten the UK's ability to combat a public health emergency such as coronavirus.

The amendments introduced a new public interest consideration for Government intervention in mergers and acquisitions. It allows the Government to intervene in mergers involving businesses with a role in combatting or mitigating the impacts of public health emergencies, such as the current COVID-19 pandemic. The economic disruption caused by the pandemic may mean that some businesses with critical capabilities are more susceptible to takeovers – either from outwardly hostile approaches, or financially distressed companies being sold to malicious parties. This change came into effect on 23 June. Other changes amended the Secretary of State's powers to scrutinise mergers in three sensitive sectors of the economy on public interest grounds: artificial intelligence, cryptographic authentication technology and advanced materials.

Separately, the Government has published its long-anticipated National Security and Investment Bill. Included in the bill is a new mandatory screening process which will require parties involved in transactions in 17 sensitive sectors (including defence, AI and others) to notify the Government. A voluntary regime will apply to other sectors where there may still be national security risks. The Government will gain powers to scrutinise, place conditions on, and block transactions where it deems there is a substantial risk to UK national security. There will also be civil and criminal sanctions for erroneous failures to notify.

Corporate Insolvency and Governance Bill

The Corporate Insolvency and Governance Bill put in place a series of urgent measures to amend insolvency and company law to support business. The BVCA had advocated for the need for some of these measures and continued our engagement with BEIS and the Insolvency Service. Alongside other measures, the Bill includes: a new moratorium to give companies breathing space from their creditors whilst they seek a rescue; a temporary removal of the threat of personal liability for wrongful trading from directors who try to keep their companies afloat through the emergency; and a temporary prohibition on creditors from filing statutory demands and winding-up petitions for COVID-19 related debt. BEIS has also published factsheets covering the details of the Bill.

Looking to the winter and a recovery

In May, the Government published a roadmap for the gradual rebuilding of the economy and this was followed with the Winter Economy Plan in September. The BVCA has outlined the vital role private equity and venture capital investment will play in the recovery in letters to the Chancellor and as part of our feedback to the Spending Review and response to the TheCityUK's recapitalisation project.

02.

Capital gains tax and carried interest

Mark Baldwin (Macfarlanes)
Abigayil Chandra (Deloitte)

02. Capital gains tax and carried interest

Mark Baldwin
Macfarlanes

Abigayil Chandra
Deloitte

The two, closely linked, topics of capital gains tax and the taxation of carried interest have occupied a significant amount of the Committee's time in the course of the last year.

There has, as everyone will know, been significant debate around the future of capital gains tax. There is an obvious need for the government to repair the public finances and one way of doing that, is to increase the rates of capital gains tax, although any such increase would be unlikely to raise a material amount of tax revenue. CGT rates are currently 20%, for most disposals by most people, with a higher rate (28%) for carried interest and "second homes". Concern that capital gains tax might be changed fundamentally (and in particular the CGT rates might be aligned with income tax rates) was driven by press and political comment but also by the Chancellor's decision to ask the Office of Tax Simplification to review capital gains tax. From time to time the OTS reviews particular taxes (some years ago it reviewed inheritance tax) and the Chancellor's explanation for his decision was simply that the OTS had never looked at CGT before, so perhaps it ought to. There has also been a level of journalistic comment, particularly in the Financial Times, around carried interest and whether the current tax position is justified.

Carried interest has, of course, been the subject of significant review and change over the last few years. The broad effect of these changes is that carried interest will only be taxed as a capital gain (and then at the higher 28% rate) if:

a. there is a significant risk when the carried interest is awarded that it will never pay out;

b. it is contingent on the fund making a profit on investments;

c. the carried interest is satisfied out of capital proceeds realised by the fund (with income distributions comprised within carried interest distributions taxed at higher rates); and

d. investments on which the carried interest depends are held by the fund long term (for 40 months or more on average), or the carried interest is subject to the comprehensive employment tax and employment related securities regimes.

All of these requirements mean that the CGT treatment will only apply to carried interest which is a long term capital investment interest. Distributions from funds which do not meet these criteria (in particular, anything which is guaranteed or risk free) will be taxed as income under the Disguised Investment Management Fee ("DIMF") rules.

Concerns around the possible future tax treatment of carried interest were increased by some of the questions the OTS invited comment on. The OTS expressed an interest in exploring the boundaries between income tax and CGT in the context of employed and self-employed people. In particular, they were interested in the extent to which individuals are (and perhaps more importantly should be) entitled to CGT treatment on the return from investments they acquire as a result of their role as an employee or a self-employed person.

Carried interest is something of a hybrid asset. In legal form it is a participation in a long term capital asset (the investment fund), but it is also clearly linked to the provision of services by individuals. But, if an individual were not providing investment services for a fund he/she would not normally be allowed to participate in the carried interest, and in most cases if an individual ceases to provide those services he will lose some or all of his carried interest. It is this link which causes some commentators to argue that carried interest returns should be taxed as income.

In our submissions to the OTS, the BVCA explained that the current tax treatment (that growth in value is, subject to detailed rules and safeguards, taxed as capital) is conceptually correct because carried interest in an investment in a long term asset which:

a. generates a return which depends entirely on the growth in value of the fund;

b. rewards managers for the durable value they have created in the fund and its portfolio companies;

c. aligns managers interests with those of investors.

In addition, the UK taxation of carried interest is in line with the position in comparable jurisdictions. This is a very important point. The Chancellor expressed a desire in his last budget to review the tax, legal and regulatory position of funds and fund managers in the UK with a view to making the UK an attractive place for them to base themselves. Clearly, this objective is not going to be achieved if the UK makes itself more expensive than other jurisdictions for individual managers to be based. The UK tax treatment of carried interest (with a minimum tax rate of 28% and the possibility of certain distributions being taxed at 45%) produces a blended rate which is well within, and somewhat towards the top end of the spectrum of effective tax rates in competitor jurisdictions. It is telling that France has deliberately amended its carried interest regime in recent years to entice managers to move there from the UK. Although, for geographical reasons if nothing else, not a direct competitor with the UK, it is interesting to note that Hong Kong set about a project similar to the Chancellor's (of building up the territory as an asset management hub) and decided, even after a number of other changes, to introduce a favourable carried interest tax regime in order to attract asset managers.

The OTS has published its first report on capital gains tax and makes no explicit mention of carried interest. There is, however, significant discussion around whether CGT should be charged at an effective rate significantly lower than income tax and some detailed exploration around the taxation of employment related securities. Even if there is no change in the UK carried interest tax regime, a significant change in the taxation of employment related securities (so that all or a significant part of the yield on those securities is taxed as income, even if received in capital form) or a significant upward movement in CGT rates generally would have a material adverse effect on carried interest recipients and this could make the UK a less attractive place to base a fund management business.

On the broader questions of whether CGT and income tax rates should be aligned and the tax treatment of employment related securities, the BVCA's view (along with that of other business representative groups) is that there should be a difference between capital gains tax and income tax rates, partly to encourage investment and risk taking but also to make sure that inflationary gains are not taxed. In the past, the UK has generally sought to create an effective difference between income and capital (even where rates were the same) by allowing individuals to index their expenditure in line with RPI or through taper relief (which reduces the amount of gain actually taxed). There are problems with both of these approaches and a reduced rate is generally thought to be a simpler and clearer method of achieving this objective. As far as employment related securities are concerned, the BVCA's view is that an individual should not face a different tax profile on the disposal of employment related securities (assuming they have been acquired at their market value) as compared to shares in third party companies. Existing legislation (which imposes an income tax charge if an individual does not pay an arms length price for the securities or if he/she disposes of them for more than they are worth or if their value is manipulated) already seeks to protect the public interest in the border between income and capital.

In a parliamentary answer over the summer, a government minister, Lord Agnew of Oulton, stressed the importance of a competitive financial services sector in the UK and explained that "the UK's approach to the taxation of carried interest remains in line with most of the G7 countries. It seeks to ensure that returns are taxed in line with their character and taxed at rates which appropriately balance the need to raise revenue with the importance of maintaining the UK's competitiveness for fund management."

Moving away from the "big picture" political arena, the Committee has also been heavily involved in detailed discussions with HMRC on their published guidance on the DIMF and carried interest regimes. When these regimes were introduced, HMRC released a draft technical note. Over the course of the autumn of last year and the spring and summer of this year, HMRC produced draft guidance on these regimes and the BVCA commented in detail on those drafts and engaged in further discussion with HMRC. In large part, that guidance has now been published in the Investment Funds Manual at IFM36000 and IFM370000, but there is still no guidance (even in draft) on the Income Based Carried Interest ("IBCI") regime. The IBCI rules are the regime which deems carried interest to be income where, broadly, a fund's investments are held on average for less than 40 months.

Although long in gestation, the guidance is quite broad and high level and leaves a number of quite important, sometimes fundamental, issues unaddressed. A key concept in both the DIMF and the carried interest regimes is that of "arising". A tax liability under these regimes is triggered when a sum "arises" (either to an individual manager or another individual or an entity with which he has a prescribed connection). Over recent years there has been significant debate between taxpayers and HMRC about how these regimes apply where amounts arise in group structures in which an individual has an interest. Linked to that is the question of how often one can look at a cashflow within a group to see whether a particular payment can still be said to be one "arising" from a fund. This is very important (and fundamental), because it could result in an individual's participation in a straightforward group structure giving rise to unexpected tax costs, simply because the business comprises or includes a fund management activity with cashflows from funds. It was possible to reach some agreement with HMRC on this point, although there is no detailed, conceptual discussion of the meaning of "arising" in the guidance. Instead, HMRC have taken some language from the BVCA's submission and included this at the beginning of the DIMF guidance. This makes it clear that the purpose of the legislation is to stop fund managers being able to obtain a tax advantage by deriving amounts from funds, rather than to create a whole new, bespoke tax regime for fund managers different from that which applies to businesses more generally. In addition, there are two worked examples in the guidance (based on examples provided by the BVCA) looking at individuals with interests in a fund management operation (one a very small interest in the very large business and the other a larger interest in a small business) and both of these examples make clear that, as long as the situation is not being exploited for avoidance purposes, the DIMF and carried interest rules should not produce a different answer for a fund manager than would be the case if that participation were held in an entity carrying on an entirely different (non-financial services) business. These are welcome confirmations and we know that they have helped to resolve (at least in part) some open enquiries between taxpayers and HMRC.

Another area of difficulty is the international element. There are many private equity executives working in the UK who are subject to US worldwide taxation. Under US tax rules, carried interest holders will incur tax liabilities early in the life of a fund (as the assets increase in value and the carried interest hurdle is passed on an accounting basis) even though they have not received any distributions. Under UK rules, a tax liability is only triggered when an amount arises to the individual (when there actually is a carried interest distribution). The UK carried interest rules include a "no double taxation" provision which allows other taxes suffered) on carried interest to be set against the tax charged under the special carried interest rules. One area of significant debate (and now uncertainty) is the extent to which this US tax (suffered early in the life of the fund) can be credited against UK tax on carried interest distributions. It has always been accepted, based on HMRC's draft Technical Note and previous correspondence with HMRC, that foreign tax can be taken into account under the "no double taxation" rule, but there is now some uncertainty around the extent to which this can be done. Under the US/UK double tax treaty, the UK has primary taxing rights and the US tax should be reduced to reflect UK tax. However, this is not how the US rules work. The US rules which give credit for foreign taxes are very restrictive and, in broad terms, UK tax suffered much later in the life of a fund would not be creditable against US tax paid much earlier in relation to the same fund. This US tax may, however, be relievable against other US tax liabilities, albeit the rules are very complicated and this will ultimately depend on the profile of a particular individual's income and gains. An open issue with HMRC is the extent to which an individual should try to obtain some form of credit for this tax in the US before seeking to reduce his UK tax liability. HMRC have not yet published the relevant passage in the draft guidance pending a full review of the position. In addition, a recent decision of the Supreme Court (in a case called Fowler) has potentially changed the way in which the DIMF rules impact on individuals who are entitled to the benefits of a double tax treaty between the UK and that jurisdiction. Again, this is an area which remains under review.

We have identified a number of areas where the published guidance either could be clarified or does not correctly reflect the legislation and continue to discuss these with HMRC. It is expected that the guidance will be amended as time goes on, and the BVCA's intention is to remain fully involved in this process.

This update has been prepared by members of the BVCA Taxation Committee and is provided on an information only basis. No responsibility can be accepted by the BVCA or contributors for action taken or not taken as a result of information contained in this article. Specific advice should always be taken in each situation.

03.

Hybrids update

Russell Warren (Travers Smith)
James Pratt (BDO)

03. Hybrids update

Background

Russell Warren
Travers Smith

James Pratt
BDO

The UK rules tackling "hybrids and other mismatches" ("the Regime") were introduced in 2017 in response to the OECD's final report on Action 2 of its Profit Shifting and Base Erosion Project (BEPS), "Neutralising the effects of hybrid mismatch arrangements". They are contained in Part 6A of the Taxation (International and Other Provisions) Act 2010 (Part 6A).

The aim of the Regime is to counteract "tax mismatches" which arise from arrangements with a hybrid element or which are designed to create that mismatch. For example, the Regime might prevent a UK company claiming a tax deduction if:

1. it has made a check the box election ("CTB Election") for US tax purposes such that both it, and its US parent can claim a tax deduction for the same payment; or
2. the deduction arises from a payment under a financial instrument designed to deliver a tax deduction to the borrower without a corresponding taxable receipt for the lender.

The Regime can also counteract an "imported" mismatch that arise between two non-UK entities – for example a UK borrower may have a tax deduction denied on a payment of interest that is "funding" a mismatch between two non-UK entities.

The Regime and accompanying HMRC guidance, which are highly complex (and have been the subject of previous BVCA Technical Bulletins[1]), have been subject to a series of developments over the nearly four year period since the regime was introduced. This process has continued over recent months with HMRC updating the guidance in August, holding a consultation that closed in August ("the Consultation") and, recently (12 November 2020), proposing a number of significant changes to the Regime ("the Proposals") following on from the Consultation. The aim of this bulletin is to update you on where we are now.

The Consultation and Proposals

As mentioned above, earlier this year HMRC held a consultation process on the Regime. The Consultation considered three specific areas where HMRC is aware that the current rules are giving rise to difficulties for taxpayers. However, HMRC received feedback on a number of other issues and, helpfully, the Proposals address several of these, with the result that they have a significantly wider scope than just the specific areas originally set out in the Consultation document.

The Proposals are to be include in Finance Bill 2021 but several of them will have retrospective effect so that they are deemed to have applied from the outset of the Regime (in January 2017). Currently, we only have detailed draft legislation for certain changes relating to the scope and use of "dual inclusion income" (discussed further below), with HMRC seeking feedback on it until 7 January 2021. In this article, we will discuss those Proposals which are most likely to be of interest to our members.

1) Double deductions

The Regime contains provisions (in chapter 9 of Part 6A (Chapter 9)) designed to counteract double deductions arising as a result of the presence in the structure of hybrid entities. These can arise where an entity is treated as opaque for tax purposes in its own jurisdiction but transparent in the jurisdiction

[1] Earlier editions of the BVCA Technical Bulletin can be found here

of one of its investors. In that situation, expenses paid by the hybrid would be tax deductible for the hybrid itself in its own jurisdiction and deductible for the investor in its jurisdiction.

An example of this could be where a UK subsidiary of a US parent makes a CTB Election to be treated as disregarded in the US. Here, absent the Regime, both the US parent and UK subsidiary would get a corporate tax deduction for expenses paid by the UK subsidiary (subject to any normal (non-hybrid) restrictions on deductibility).

As originally drafted, the hybrids rules sought to counteract double deductions caused by hybridity where, broadly,

- the hybrid entity and investor are related or the arrangement is designed to deliver (or share the economic benefit of) the double deduction; and
- either entity is within the charge to corporation tax, unless the double deduction is against "dual inclusion income". However, HMRC recognised that the exclusion for "dual inclusion income" was not wide enough to prevent the hybrids rules disallowing deductions in certain common benign situations where the income of the hybrid consists of payments from the investor that the investor funds out of its own related income.

An example of when this situation would arise would be where a US asset management entity has a wholly owned UK sub-advisor company which has checked the box. Where a third party fund management fee is paid to the US parent and then on-paid as a sub-advisory fee to the UK company, there would be no "dual inclusion income" as the income of the UK company (the sub-advisory fee) would not be recognised in the US (which would only recognise the third party management fee). This would mean that the UK company would not get a corporation deduction for its expenses (e.g. employee salaries).

To address this problem the hybrid rules were amended in 2018 (with retrospective effect to the introduction of the regime) to introduce the concept of "section 259ID income". If the hybrid entity is a UK corporation taxpayer and the income is section 259ID income, then there is no disallowance. Broadly, section 259ID income arises where the investor receives a payment of taxable income from a third party and, as a "direct consequence" of that payment, makes a payment to the hybrid which gives rise to taxable income for the hybrid but not a tax deduction for the investor. The "section 259ID income" is the lesser of the two payments (i.e. the payment by the third party to the investor and the payment by the investor to the hybrid).

However, in practice, the conditions for income to be section 259ID income are drafted so narrowly that there is real doubt as to whether many common and benign situations are covered by this exclusion from counteraction under the Regime. For example, if we build on the example given above so that instead of the UK company being a sub-adviser of its US parent, it is instead a sub-adviser of a sister company which has the same US parent and which has entered into the fund management agreement with the third party. Here, if a CTB Election has also been made to treat the sister company as a disregarded entity, section 259ID may not apply as the sub-adviser fee would not come from the investor (i.e. the US parent).

Under the Proposals, the whole concept of section 259ID is to be abolished and instead the definition of "dual inclusion income" in Chapter 9 will be expanded to include "inclusion/no deduction income". This change is to have retrospective effect back to the beginning of the Regime. Inclusion/no deduction income is, broadly, taxable income of the payer which is not deductible for any person where the reason for such non-deductibility is the hybridity of the payer. Looking at the scenario discussed in the preceding paragraph, a sub-advisory fee paid to the UK sub-advisor by either the US parent or a US sister company (in relation to which a CTB Election has been made) should be inclusion/no deduction income.

This is a welcome development, however, it should be noted that it does not fully prevent the double deductions rules applying in common benign scenarios. This can be illustrated by turning back to our example. If the sister company were located in a third party jurisdiction, it is likely that it would receive a local tax deduction for the sub-advisory fee such that the fee could not be “inclusion/no deduction income”. In fact, HMRC recognise that their proposal is not a complete answer to the underlying issue and, in a document summarising the responses to the Consultation that accompanied the Proposals, HMRC explain that they considered various other solutions and set out why they were rejected (for example, allowing a just and reasonable apportionment would have led to too much uncertainty).

2) Further points on dual inclusion income

The Proposals also contain amendments to the definition “dual inclusion income” where it is used in certain other chapters of Part 6A. In particular, the concept of “inclusion/no deduction income” (see above) is introduced in the chapter that deals with deduction/non-inclusion mismatches caused by hybridity (e.g. where a payment is made to its US parent by a UK company that has made a CTB election) and a similar concept of “excessive PE inclusion income” is introduced into the chapters that deal with double deduction or deduction/non-inclusion mismatches caused by the presence of a permanent establishment. Again, these changes are to have effect back to the introduction of the Regime.

Another significant change relating to dual inclusion income is that, under the Proposals, companies will be able to surrender it to other members of their group that would otherwise be subject to counteraction under the Regime. This change is envisaged to come into effect in relation to accounting periods of claimant companies ending after 1 January 2021.

3) “Acting together”

The concept of parties “acting together” is important for the purposes of the hybrids regime. This is because the impact of parties acting together is, broadly, that the aggregate rights and interests those parties have in another person are attributed to each other when assessing whether either of those parties controls or is related to that other person. The presence of a control relationship or persons being related is often critical for the hybrids rules to apply. However, the concept of “acting together” is defined very widely.

Lenders

One aspect of this is that the rules deem two parties (X and Y) to be acting together in relation to a third person where X and Y are party to any arrangement that:

- it is reasonable to suppose is designed to affect the value of any of X’s rights or interests in relation to that third person; or
- relates to the exercise of any of X’s rights in relation to that person.

This deeming provision potentially applies to common arrangements between third party lenders and parents of borrowers. For example, loans subject to inter-creditor agreements or including group-wide behavioural covenants.

Under the Proposals, this part of the “acting together” test will be amended, with retrospective effect to the introduction of the Regime, so that it is disapplied where a party has a direct or indirect equity stake in a paying entity no greater than 5%, including votes and economic entitlement.

10% threshold for funds structured as partnerships

Under the proposals, the “acting together” definition will be amended to exclude any investor holding less than 10% of a partnership that is a collective investment scheme, whilst providing against fragmentation of interests. This change is to have effect from the date of royal assent to the Finance Bill 2021.

4) Exempt investors in hybrid entities

Counteraction can apply under the Regime (chapter 7 of Part 6A (Chapter 7)) where a hybrid entity receives a payment which is deductible by the payer but which does not give rise to taxable income for either the hybrid or an investor in it (e.g. if the hybrid is tax transparent in its own jurisdiction but treated as opaque in the jurisdiction of an investor). However, as the rules are currently drafted, this counteraction will apply where the investor is a tax exempt investor (e.g. a pension fund). Effectively the hybrid rules attribute the non-taxability of the payment to the presence of the hybrid entity, even if the investor would not have been taxed had it received the payment directly.

The Proposals seek to address this issue by amending Chapter 7, from the date of royal assent to the Finance Bill 2021, to prevent counteraction where the recipient falls within a category of tax exempt investor akin to the category of “qualifying institutional investor” within the substantial shareholding exemption rules for corporation tax on capital gains.

Although the Consultation only raised this issue in the context of Chapter 7, respondents pointed out that the same point could arise in relation to chapter 5 of Part 6A which potentially applies counteraction where a (potentially deductible) payment is made by a hybrid which is not recognised as taxable income for the investor (e.g. where a payment is made to its US parent by a UK company that has made a CTB election). Helpfully, HMRC have said that the proposed exemption would also apply in this situation.

5) Imported mismatches and equivalent regimes

In applying the UK hybrid rules it is important to understand whether a provision of the law of a territory outside the United Kingdom is “equivalent” to those rules (or a provision of them). This is because this concept of equivalence is used widely in the hybrids regime including, in several situations, in limiting possible counteraction. One aspect of this is that, broadly, counteraction is only possible under the “imported mismatch” rules (chapter 11 of Part 6A (Chapter 11)) if it is reasonable to suppose that no non-UK provision equivalent to the other charging provisions of Part 6A applies or will apply. The imported mismatch rules seek to deny deductions where, in essence, the relevant payment funds a hybrid mismatch between two non-UK entities.

HMRC accept that determining equivalence for the purposes of the imported mismatch rules can be problematic because it (i) requires consideration of specific provisions of foreign regimes (which must be equivalent to specific provisions of the Regime), rather than the overseas regime as a whole and (ii) raises the question of whether equivalent provisions can be said to “apply” where no counteraction ultimately results.

To address both these proposals it is envisaged that, from royal assent to the Finance Bill 2021, the equivalence condition in Chapter 11 will be changed so that it tests whether an overseas regime as a whole can be seen as equivalent to the Regime.

This Proposals builds upon the additional guidance HMRC provided on the equivalence test in August 2020 (see below).

6) Interaction with transfer pricing

As we discuss below, the August 2020 update to HMRC's guidance contains a lot of new material on the interaction between the Regime and the transfer pricing rules. The Proposals also are relevant to this issue.

The Proposals address a concern that unfairness can arise where counteraction applies under the current imported mismatch rules to a payment by a UK company which is also subject to a transfer pricing adjustment. In that case, there is a concern that the size of the counteraction under the Regime is excessive, because, broadly, it is computed by reference to the size of the imported (non-UK) mismatch, which will not have been subject to a UK transfer pricing adjustment, rather than the size of the UK payment which has been subject to such an adjustment. Therefore, under the Proposals (which are slightly unclear on the point) it appears that, the imported mismatch amount, as defined, is to be computed in all respects as if the amount deemed to be funded by a payment from the UK was reduced by an amount equal to the transfer pricing adjustment suffered by the UK payer.

In addition, HMRC have said that the transfer pricing rule that, broadly, in certain circumstances allows a guarantor to claim deductions for deductions disallowed to the borrower will be amended to prevent it effectively unwinding a counteraction under the Regime by virtue of a corresponding adjustment in another group company.

The August 2020 update to HMRC's guidance

Interaction with transfer pricing

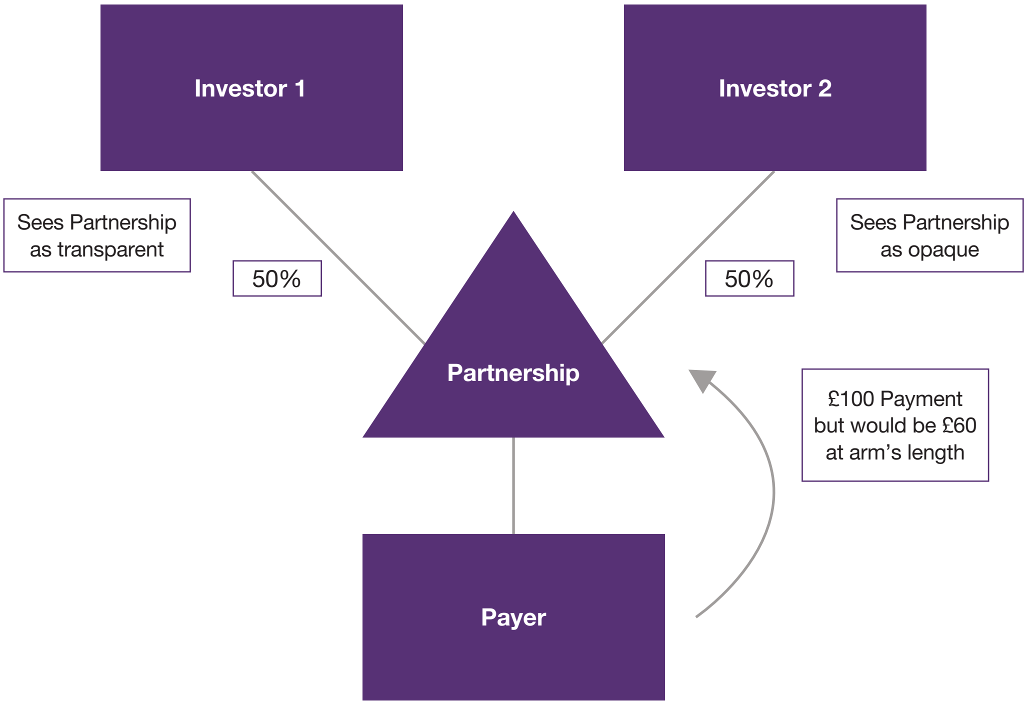
The August update to HMRC's guidance contains a lot of new material on the interaction between the transfer pricing and hybrids regimes. The position set out in the previous guidance made clear that both sets of rules needed to be applied but contained only a short and overly simplistic discussion in which HMRC said that a similar result would arise whichever order the two regimes were applied in. However, as we pointed out to HMRC, that is not necessarily the case. This had led to taxpayers (and, indeed, we understand, individual HMRC inspectors) taking different positions on the issue.

Helpfully, HMRC's position on the interaction between the hybrids and transfer pricing regimes has been significantly refined and clarified in the new guidance. However, this appears to have brought with it much increased complexity. Under the new guidance, whilst both sets of rules are still to be applied, HMRC provide a lot more detail (in 27 new pages) on the manner in which that should be done. The process essentially consists of a two stage process:

1. determine under the transfer pricing rules whether a person is in a tax advantaged position under the non-arm's length (i.e. actual) transaction as compared to an arm's length (notional) transaction, taking the Regime into account for both transactions; and
2. consider the Regime in respect of the transfer priced outcome to see if any further restriction arises. When doing this, transfer pricing is assumed to have applied so that the arm's length amount is used but without taking into account the application of the Regime.

Where a payer suffers a transfer pricing adjustment, a recipient is still able to make a corresponding adjustment claim under the UK transfer pricing rules (i.e. it can prepare its returns on the basis that it received an arm's length amount rather than the actual amount). However, where a corresponding adjustment claim is made, whether by a UK payee under the UK rules or an oversees payee under its own law or applicable treaty, that claim will reduce the amount of ordinary income received by that payee where relevant to the application of Part 6A.

Example of how the rules would work in a hybrid payee context



Stage 1: Apply transfer pricing

- **a.** Tax position of actual arrangement: under the Regime £50 of the deduction would be restricted (and only useable against "dual inclusion income") so total deduction for normal use by the payer of £50
- **b.** Tax position of arm's length arrangement (£60 payment): under the Regime £30 of the deduction would be restricted (and only useable against "dual inclusion income") so total deduction for normal use by the payer of £30

As the actual arrangement gives a greater deduction than the arm' length arrangement, transfer pricing will apply to reduce the payer's deduction to the arm's length amount, including the impact of the hybrid rules (i.e. that set out in b).

Stage 2: Apply Regime to see if there is further counteraction

- **a.** The payer is treated as making a potentially deductible payment of £60 (i.e. the arm's length amount).
- **b.** As only £50 of income is recognised by the payees (as Investor 1 does not recognise any), there is a hybrid payee deduction/non-inclusion mismatch of £10 (and that amount can only be used against dual inclusion income).

As stage 2 gives a lesser counteraction than stage 1, it has no effect in practice. (If Investor 2 had made a transfer pricing corresponding adjustment (so only recognising 30 of income), stage 2 would have imposed the same counteraction as stage 1.)

HMRC point out that where the relevant chapters of Part 6A are those dealing with hybrid financial instruments (or hybrid transfers) it is possible that on an arm's-length basis the relevant provision would not have included hybrid features. In that case, in effect the regimes will not apply cumulatively, whichever gives rise to the greater disallowance looked at in isolation will prevail.

Equivalent provisions in foreign jurisdictions

As discussed above, in applying the Regime it is important to understand whether a provision of the law of a territory outside the United Kingdom is "equivalent" to those rules (or a provision of them).

The legislation (s259BA) tells us that there are two conditions for equivalence. It must reasonable to suppose that the foreign law (i) is based on the final BEPS Action 2 report (or any replacement or supplement), and (ii) has effect for the same, or similar purposes to Part 6A (or the relevant provision of it). However, this still leaves the question as to whether HMRC will consider that any given foreign law provision will meet this test. In particular, as EU member states have been required to implement anti-hybrid measures contained in the current iteration of the EU anti-tax avoidance directive (ATAD 2) since 1 January this year, taxpayers have wanted to know if the various member states' domestic laws effecting this implementation meet the requirements for equivalence.

The new guidance is fairly helpful on this point. HMRC confirm that they consider that ATAD 2 meets the equivalence requirement and that, accordingly, where the equivalence of an EU member state's entire regime is being considered, the equivalence test should be met provided that it implements ATAD 2 in full. This will be the case even where the outcome of applying the foreign regime differs to that which would have resulted from applying Part 6A to a similar fact pattern. However, where the EU member state is held (by the EU Commission, the Court of Justice of the EU or a competent domestic court in the relevant state) not to have properly implemented ATAD 2 in any respect which is material to the UK tax analysis, HMRC will regard chapter 12 of Part 6A as applicable. Under that chapter adjustments to a taxpayer's position can be made where a reasonable supposition that was previously made for the purposes of Part 6A turns out to be mistaken or ceases to be reasonable.

The position is different where Part 6A requires a specific provision within that part to have a foreign equivalent. In that situation HMRC say that it will be necessary to demonstrate that such a specific provision exists overseas (i.e. it is not enough that the foreign regime as a whole is equivalent).

Conclusion

Based on the information that HMRC has so far published, the Proposals appear to be a very welcome step, addressing several longstanding problem areas, albeit it is a little disappointing that international groups (and US-headed ones in particular) are still likely to encounter double deduction issues. Clearly much will turn on the details of the legislation (of which we have little at the moment) and it is awaited with interest.

In addition the changes to the guidance made in August give some helpful further clarifications as to HMRC's approach to application of the hybrids regime. That being said, HMRC's new approach to the interaction of the transfer pricing and hybrids regime, requiring both transfer pricing calculations incorporating hybrids analysis followed by a separate hybrids analysis, will give rise to extra complexity for many taxpayers.

This update has been prepared by members of the BVCA Taxation Committee and is provided on an information only basis. No responsibility can be accepted by the BVCA or contributors for action taken or not taken as a result of information contained in this article. Specific advice should always be taken in each situation.

04.

Notification of uncertain tax treatments consultation

Jon Page (PwC)

04. Notification of uncertain tax treatments consultation

Jon Page
PwC

During the 2020 Budget, it was announced that the government intends to require large businesses to notify HMRC where they have adopted an "uncertain tax treatment", with the aim being to enable HMRC to identify where businesses have adopted a different legal interpretation to the HMRC view. A consultation document was published to that effect, to which several parties, including the BVCA responded during the summer.

What is the consultation about?

HMRC is seeking to impose a new notification requirement on large businesses that adopt an "uncertain tax treatment". An uncertain tax treatment is described in the consultation document as "one where the business believes that HMRC may not agree with their interpretation of the legislation, case law or guidance".

The rule whilst being similar to the existing IFRIC23 -Uncertainty over income Tax Treatments, applies a different test to whether a position is notifiable. The IFRIC test requires an assessment of whether it is probable that a tax authority (including a court) would accept a particular treatment whereas this test considers whether HMRC would be "likely" to challenge an interpretation. Clearly this provides the potential for considerable uncertainty and make it difficult for taxpayers and their advisers to interpret.

This proposed notification requirement is designed to ensure that HMRC are made aware of cases where a large business has adopted a treatment with which HMRC may disagree and to accelerate the point at which discussions occur on these positions.

What is a large business for these purposes?

This is perhaps the key question for most Funds and was the focus of the BVCA representations.

HMRC will model their definition of a large business on the existing Senior Accounting Officer ("SAO") and Publication of Tax Strategies ("PoTS") regimes. Businesses will broadly fall within these regimes if they satisfy either or both of the following:

- Turnover above £200m
- Balance sheet total above £2bn

The consultation made clear that partnerships and LLPs would be expected to comply with this measure if they satisfy the thresholds– it does not only apply to corporates. The measure will apply to the following taxes: Corporation tax, Income tax (including PAYE), VAT, Excise and Customs Duties, SDLT & SDRT amongst others.

What needs to be reported?

It is proposed that any uncertain tax treatments that have a tax impact in excess of £1m should be considered.

BVCA Response

As above the BVCA's primary concern when responding to the consultation was the potential for the size limits to be aggregated between portfolio companies or the fund group. Clearly if a portfolio company is large in its own right it should comply with the rules but it would be inappropriate to apply the rules to smaller or medium sized entities that had merely been aggregated together by common ownership.

Application to partnerships and aggregation

HMRC's intention is to model the size threshold test on the definitions of large businesses included in the SAO and PoTS regimes. The end result is somewhat unclear as these regimes use different definitions, particularly with regards to aggregation. The method of aggregation in the SAO regime means that its application is wider than that of the PoTS which uses the accounting standard of consolidation to determine whether its thresholds are breached. Clearly the final test for these thresholds will be of key importance to Funds.

Fund partnerships

As above the legislation will apply to partnerships and LLP's as well as UK incorporated companies, therefore an investment fund partnership is likely to be within the regime if it has turnover and or balance sheet assets above the threshold. However, it is not clear whether this is intended. By and large the fund partnership will not have any tax liability itself and its investors will predominantly be non-resident institutions with no UK tax liability and therefore the BVCA requested that the rules should not apply to collective investment scheme limited partnerships.

Fund managers

Similar to the position for portfolio companies there will be instances where the fund manager is considered large enough or part of a large corporate group such that it will pass the gateway threshold in its own right but again the managers position should be considered separately to that of the fund or the portfolio companies.

Conclusion

On 12 November 2020, the Financial Secretary to the Treasury announced that the implementation of the new requirement for large businesses to notify HMRC of uncertain tax treatments will be delayed until April 2022. We hope that HMRC's next update will take into account the BVCA's comments, on aggregation, as these have the potential of making this notification requirement burdensome on the industry.

05.

DAC6: Where are we with the main benefit test and investor negotiations?

Paul Eastham and Charlie Cartiglia (Debevoise & Plimpton)

05. DAC6: Where are we with the main benefit test and investor negotiations?

Paul Eastham
Debevoise & Plimpton

Charlie Cartiglia
Debevoise & Plimpton

Filings under DAC6 are now underway in certain jurisdictions, most notably Germany, and will be due early next year in the rest of the EU and the UK. This means that certain issues, discussed by sponsors and investors for some time now, require a more decisive position to be taken.

This article discusses the application of the "main benefit test" (or "MBT"), which will often be a central concept in determining whether certain hallmarks apply to a fund structure (and, therefore, whether it is reportable), and how sponsors and investors might deal with DAC6 reporting in their fund documents.

We assume a certain level of knowledge of DAC6. For a general overview of DAC6, please see the BVCA Technical Bulletin of November 2019 and, for a discussion of certain DAC6 administrative issues, please see the BVCA Technical Bulletin of May 2020.

Main benefit test: application to fund structures and interpretation

Certain hallmarks under DAC6 that are relevant to funds only apply if the MBT is satisfied. The MBT will be satisfied if it can be established that the main benefit or one of the main benefits which, having regard to all relevant facts and circumstances, a person may reasonably expect to derive from an arrangement, is the obtaining of a tax advantage.

In discussions around DAC6 and fund structures, the application of the MBT comes up time and again in relation to the scenarios described below. In addition to commenting on these specific scenarios, this article looks at some key sources that may generally influence MBT interpretation.

Luxembourg alphabet shares

Luxembourg alphabet or tracking shares are commonly used in fund investments. Such shares are generally the subject of partial liquidations which result in capital returns to shareholders in both Luxembourg and other jurisdictions, including the UK, regardless of the nature of the underlying profits. Such returns are made free of withholding tax in Luxembourg.

From a DAC6 hallmarks perspective, these structures may have the effect of converting income into capital (thus falling within hallmark B2, subject to the MBT). It should be noted that these structures will not universally be reportable. For example, it may be that the underlying returns are gains so that there is no conversion of income to capital, or that income is paid as income through the structure without any conversion. However, if the underlying receipts of the Luxembourg company take the form of income, the MBT will require close consideration.

Alternatively, we are aware that some advisors in certain jurisdictions (e.g. Germany) consider that the governing documents of certain Luxembourg companies with alphabet shares are "substantially standardised" (thus falling within hallmark A3, subject to the MBT). This appears to be an unusually broad interpretation of this hallmark relative to many other jurisdictions; in the UK, such hallmark would tend not to apply to precedent agreements that, at the very least, need to be reviewed to check their suitability for the transaction in hand.

In terms of approach to the MBT, it is understood, importantly, that the Luxembourg tax authorities are not expecting these structures to satisfy the MBT on the basis that they operate entirely as anticipated by the tax authorities. Moreover, the preamble to the DAC6 Directive states repeatedly that the DAC6 regime is targeted at "potentially aggressive tax-planning arrangements"; it may be possible to consider that standard and accepted arrangements in the country in which they are established ought not to be regarded as "aggressive" in appropriate instances (see *MBT interpretation, generally,* below).

It bears mentioning, however, that Luxembourg alphabet share structures should always be considered on a case-by-case basis in an MBT analysis.

Payment of fees and interest to "associated" LPs and GPs

Deductible payments (such as fees and interest) to "associated" entities are common within fund structures, and the recipients are often in low or no tax jurisdictions, exempt from tax on the payments or benefit from a "preferential tax regime" (thus potentially falling within hallmark C1). Each vehicle within a fund structure is likely to be an associated enterprise of each other vehicle within the fund structure. External investors will generally be an associated enterprise of fund vehicles in which they hold a ≥25% interest (direct or indirect).

Key examples of payments that might bring hallmark C1 into play are management fees paid to offshore GPs and payments of interest or fee income to investors in managed accounts or funds-of-one or anchor investors (i.e. ≥25%) that are, in each case, established in low-tax jurisdictions or benefit from a preferential tax regime. It is also possible that the interests of investors that are under common control may be aggregated when assessing their association with a fund structure. Separately, certain entities (e.g. Luxembourg securitisation vehicles) may be eligible for special treatment rendering a range of payments "deductible" beyond those generally anticipated; this widens the potential need to consider this hallmark.

The approach to the MBT will vary from situation to situation: for example, pension funds are indubitably subject to a preferential tax regime in most jurisdictions, but few would suggest that deductible payments to an associated pension fund investor would result in a reporting obligation (because many jurisdictions intend pension funds to be exempt from tax on investment income), except under the rarest of circumstances. In less clear instances, the MBT will need to be carefully considered on a case-by-case basis (see *MBT interpretation, generally,* below).

For completeness, note that, in cases where the "associated" recipient of a deductible payment is not resident anywhere for tax purposes or is resident in a "blacklisted" jurisdiction, a DAC6 report will be strictly required, however benign the intentions.

Payments to the Cayman Islands

The removal of the Cayman Islands from the EU "blacklist" was greeted with universal relief from those involved with DAC6 reporting, owing to the point made above that deductible payments made to "associated" recipients in a blacklisted jurisdiction are automatically reportable.

However, caution may be needed since some EU Member States' draft guidance currently suggests cross-border payments with a Cayman recipient should be reportable if Cayman was blacklisted as at the date of a reporting trigger, notwithstanding Cayman's subsequent removal. It remains to be seen whether guidance with this indication will be updated to account for the specific circumstances of the Cayman Islands' temporary blacklisting.

The UK tax authorities' guidance appears to suggest that any such arrangements with Cayman since 18 February 2020 should not be reportable in the UK, provided the Cayman Islands is not on the blacklist on both (i) the date of any reporting trigger *and* (ii) the filing date (being 1 January 2021 given recent deferrals to the reporting deadline).

For the avoidance of doubt, the Cayman Islands are still a "low-tax jurisdiction" for DAC6 purposes, so the comments in *Payments of fees* and interest to GPs and "*associated*" LPs, above, will apply to fund structures and investors using Cayman entities.

Blocker structures

Blocker vehicles (and other feeders) in a fund structure will usually be "associated" with other fund vehicles and are often established in low-tax jurisdictions and/or may otherwise fall within hallmark C1. Such vehicles are established for a range of reasons, including, commonly, for managing US tax administration or ensuring that a US investor is not disadvantaged by investing through a fund.

A key consideration regarding the MBT in the context of blocker vehicles established to deal with US (and other non-EU) tax issues is whether the relevant intermediary's jurisdiction views a non-EU tax advantage as a relevant "tax advantage" under the MBT. Many EU Member States' tax authorities have indicated a relatively clear position: for example, the UK and Ireland do not, while others, such as Germany and Luxembourg, do.

If the non-EU tax advantage is relevant, or if the blocker deals with EU tax concerns, closer consideration of the MBT will be required. In that regard, the references in the DAC6 preamble to it tackling "potentially aggressive tax-planning arrangements" could influence the MBT's application to blockers, particularly where the objective is more administrative than tax-saving (see *MBT interpretation, generally*, below).

MBT interpretation, generally

Two sources that may be of particular assistance when analysing MBT issues in fund structures are: the preamble to the DAC6 Directive; and, of particular relevance to UK sponsors, investors and advisers, the UK's case law on rules similar to the MBT.

The DAC6 Preamble

EU case law suggests that there is a reasonable argument that regard may be paid to the preamble of a directive. Recitals can help to explain the purpose and intent behind an actual instrument.[2] They can also be taken into account to resolve ambiguities in the legislative provisions to which they relate.[3] However, they cannot be read as actual legislation and, particularly, cannot be used to argue against something which is clear on the face of the legislation.[4]

In the case of the MBT, references to "relevant facts and circumstances" and benefits that a person may "reasonably be expected to derive" give some ambiguity to the legislation and thus it would seem legitimate to argue that the preamble can be used as a factor to consider in the context of the MBT.

The DAC6 preamble conveys that DAC 6 is aimed at protecting the tax bases of EU countries from increasingly sophisticated tax structuring. It is stated in a number of places that it is targeted at "potentially aggressive tax-planning arrangements." This would suggest that the MBT's relevant facts and circumstances include considering the overall "aggression" of the structure and its substantive effect.

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[2] Case C-244/95, Moskof, [1997] ECR I-6441, Case C-173/99 BECTU [2001] ECR I-4881
[3] Case C-435/06, C [2007] ECR I-10141, paras. 51-52
[4] (Case 215/88 Casa Fleischhandels [1989] ECR 2789, para. 31). Additionally, 'the preamble to a Community act has no binding legal force and cannot be relied on as a ground for derogating from the actual provisions of the act in question or for interpreting those provisions in a manner clearly contrary to their wording…' (Case C-162/97 Nilsson [1998] ECR I-7477, paragraph 54'19

Paying the right amount of tax

It is also important that the MBT not be viewed as suggesting that any structure which does not result in payment of the maximum amount of tax possible is somehow impacted. In the UK at least, the case law in this area suggests otherwise. The case of *Inland Revenue Commissioners v Brebner (1967) 2 AC 18* is a helpful reminder that, while the "main object" test (the test relevant to this decision) is a question of fact and a subjective matter of intention, it remains the fact that, as Lord Upjohn said, "no commercial man in his senses is going to carry out a commercial transaction except upon the footing of paying the smallest amount of tax that he can" and thus no inference can be drawn from adopting a course which pays the least amount of tax possible or none at all. In *Ladbroke Group International v HMRC (2018) 723*, in looking at the issue of "main purpose or one of the main purposes", the court made it clear that a purpose could be "more than trivial" without being a "main" purpose and that "main" had a connotation of importance. It is not necessarily the case that, in the context of overall commercial aims, a desirable tax result will automatically cause a structure to fail the MBT.

The above is merely designed to identify certain potentially helpful factors in analysing the MBT and it is still not possible for a uniform, firm "position" to be taken on the MBT in all instances. Funds should still consult advisers and consider the relevant facts and circumstances.

Investors' role and documentary protection

Investors are becoming increasingly focused upon obtaining appropriate side letter or other comfort on DAC6 issues in terms of fund and investment structuring. Sponsors can be faced with alarmingly broad requests on compliance with DAC6 and the provision of information. This can be particularly so when investors propose that a GP, whose role can fall short of "intermediary", be held responsible. Changes in market practice mean that it can be challenging to oppose these requests in their entirety, especially since doing so may be interpreted as not engaging sufficiently seriously on compliance. However, armed with an understanding of how investors will generally fit within the ambit of DAC6, sponsors should be able to tailor protection so that it is reasonable, while not being unduly burdensome.

The role of investors (and indeed their advisers) will, in many cases, fall short of "intermediary" status in relation to fund and investment structures. An intermediary must be involved to some degree in designing, marketing, organising, implementing or making available for implementation a potentially reportable arrangement under DAC6.[5] In the case of managed accounts, co-investment vehicles or anchor investors, there may be occasions upon which an investor can be regarded as meeting one of more of these levels of involvement. However, your typical investor in a widely held fund, even if aware of probable investment holding structures (for example, via the offering documents), is unlikely to meet any of the intermediary tests on technical analysis. Their role is to make the investment in the fund offered to them and to negotiate terms of such investment, which rarely results in intermediary status in relation to the fund or its "downstream" structures.

If not intermediaries, investors in the EU may be "relevant taxpayers" for the purposes of some reports. From a compliance perspective, this should only have an impact under DAC6 if there is no intermediary at all or no intermediary is required to file a report due to legal professional privilege. In such cases DAC6 mandates that the relevant taxpayer is required to report, but neither is a likely scenario in a fund structure. Certain jurisdictions (an example being Germany) do, admittedly,

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[2] For more detail on some of the considerations required around who is an intermediary for the purposes of DAC 6, please see the article in the BVCA Technical Bulletin of May 2020.

require that relevant taxpayers file reports if the intermediaries merely fail to do so, but this is not universal. If neither intermediary nor relevant taxpayer, EU investors may need to be named on DAC6 reports as "likely to be affected" by an arrangement but this does not bring with it any practical obligation.

The foregoing considerations mean that fund sponsors may legitimately ask the rationale for certain language, e.g. requiring reference numbers for all DAC6 reports made on behalf of a fund. It is often appropriate to limit requirements to circumstances in which investors are named as intermediaries (or as relevant taxpayers if this results in a potential reporting obligation if no intermediary files) and where the relevant filings or information are within the control of the GP. Equally, although being identified as "likely to be affected" or as a "relevant taxpayer" in a DAC6 report has no technical impact, meaning that formal provision may be legitimately resisted by a sponsor, it is probably important to assure investors that sponsors will nonetheless advise them if such identification occurs.

Again, these matters should always be considered on a case by case basis and the foregoing is intended only to highlight potential considerations.

Brexit

Finally, it bears mentioning that potential issues surrounding Brexit are increasingly being considered in a DAC6 context. For example, although the position remains uncertain, funds with the "option" of reporting in the UK or another EU Member State (for example, because there are intermediaries in more than one jurisdiction) may consider reporting in the latter over the former, to avoid potential issues regarding the ability to rely, in an EU Member State, on a DAC6 report having filed in the UK in order to discharge a reporting obligation in such EU Member State following the UK's leaving the EU.

Many thanks are due to BVCA Tax Committee members Jenny Wheater at Debevoise & Plimpton, Clare Copeland at Carlyle and Jose Maria Palicio at Permira for their review, comments and insight on this article.

This update has been prepared on behalf of the BVCA Taxation Committee and is provided on an information only basis. No responsibility can be accepted by the BVCA or contributors for action taken or not taken as a result of information contained in this article. Specific advice should always be taken in each situation.

06.

Investment Firms Prudential Regime

James Smethurst (Freshfields)

06. Investment Firms Prudential Regime

James Smethurst
Freshfields

Introduction

On 27 November 2019, the European Union's Investment Firm Regulation ("IFR") and Investment Firm Directive ("IFD") were passed. When both measures come into force in the EU (due to be 26 June 2021) they will replace the existing capital framework for investment firms with a completely new regime. In addition, the IFR and IFD will introduce new rules for liquidity, remuneration, reporting and group supervision. The objective behind the new rules is to introduce a regime which is specifically designed for investment firms, replacing the current rules which are essentially the rules for banks, modified for investment firms.

The position for UK firms is complicated by Brexit. Because the transposition and implementation date for IFD and IFR comes after the end of the transition period, the UK is not required to bring these rules into force. The UK Government and FCA have made it clear that they intend to introduce a regime for UK investment firms (UK firms which are authorised to provide MiFID investment services and activities), and it is likely that this will closely follow the IFR and IFD. In June, the FCA published a Discussion Paper (DP20/2 A new UK prudential regime for MiFID investment firms) which set out the FCA's initial thinking. A Consultation Paper with draft rules is expected to follow, possibly before the end of 2020. The UK has also announced a target date of 1 January 2022 for UK implementation.

In this article we consider what the key impacts of the new investment firm regime will be for private equity firms. We do not yet know exactly how the regime will be implemented in the UK, and the impacts described are based on the assumption that the UK will follow the EU rules closely. It remains to be seen whether the FCA will modify the rules to mitigate some of the most significant impacts. The BVCA has been actively engaging with HM Treasury and the FCA to try to ensure that the UK regime is appropriately calibrated for the private equity and venture capital industry.

Overview – tiers of investment firms

A key feature of the new regime is that investment firms are categorised into different types based on a combination of the activities they undertake and their size. The very largest investment firms that have permission to 'deal on own account' and underwrite transactions will continue to be subject to the same rules as banks. For private equity and venture capital firms which are authorised in the UK with permission to advise on investments and arrange deals in investments ("adviser arrangers"), or which are AIFMs with top-up permissions, the key question will be whether they qualify as 'small non-interconnected firms' ("SNIs"). This is because SNIs are subject to much lighter rules than other investment firms.

There are a number of tests to determine whether a firm is an SNI. Of particular relevance to private equity firms are:

- assets under management must be less than €1.2 billion;
- the firm cannot hold any client money or custody client assets;
- the firm's on and off-balance sheet total must be less than €100 million; and
- the total annual gross revenue from investment services and activities must be less than €30 million.

In determining whether a firm crosses the threshold for assets under management, on and off-balance items and gross revenues, the aggregate figures for all investment firms in the group are taken. It remains to be seen how this will be applied in the UK, and whether it will only be the aggregate of all UK investment firms in the group.

Firms which do not qualify as SNIs are subject to the full regime. However, there are further, specific derogations and modifications which apply to particular aspects of the new regime – such as parts of the remuneration rules – which may still apply to individual firms even if they are not SNIs.

Capital Requirements

The capital requirements for investment firms are central to the new regime. SNIs will be required to hold capital which is the higher of a fixed overhead requirement ("FOR") and their permanent minimum capital requirement (essentially the base capital level). The FOR is calculated as one quarter of the firm's fixed overheads for the preceding year. For adviser arrangers who do not have permission to hold client money, their permanent minimum capital will be €75,000 (this increases to €150,000 if the firm can hold client money). Applying a FOR is likely to significantly increase the capital requirement for adviser arrangers that currently have a flat €50,000 capital requirement in the UK.

For firms which are not SNIs, their capital requirement will be the higher of the FOR, their permanent minimum capital requirement and a capital requirement calculated by applying the 'K-factors'. The K-factors are intended to capture different activities conducted by investment firms and to address the risk to clients, risk to the firm and the risk to the market of the different activities. For private equity and venture capital firms who do not generally deal in investments, most of the K-factors are not relevant. However, there is a K-factor for assets under management, which covers both discretionary portfolio management activity and non-discretionary arrangements constituting investment advice of an ongoing nature. The exact scope of the latter activity is not entirely clear, and it will be important to see how this is approached in the UK.

Liquidity

In addition to capital, the new investment firm regime introduces a liquidity requirement which will be a change for many firms. Under the IFR all firms, including SNIs, are subject to the liquidity requirement unless the relevant regulator exempts them from the requirement. In its Discussion Paper, the FCA indicated that it thought the minimum liquidity requirement was appropriate for all firms, suggesting that there would be no exemption in the UK for SNIs.

To meet the liquidity requirement, firms will have to hold at least one third of the FOR in liquid assets. These include cash and certain 'high quality liquid assets' such as government bonds. Certain liquid assets will be subject to a 'haircut' (i.e. a discount will be applied to their value when assessing their contribution to meeting the liquidity requirement). For many firms, particularly smaller firms, this will effectively mean that one third of their FOR will be held as cash.

Remuneration

The IFD contains new remuneration rules. These rules will not apply to SNIs. For all other firms, the rules will require them to have a remuneration policy applicable to senior managers, risk takers, staff engaged in control functions and other employees who receive remuneration equivalent to that of senior management, whose professional activities have a material impact on the risk profile of the firm ("material risk takers").

Variable remuneration which is paid to material risk takers must comply with certain requirements. These include requirements that: (i) at least 50% of variable remuneration is paid in certain financial instruments (such as shares in the firm); (ii) at least 40% of variable remuneration must be deferred over a three-to-five-year period; and (iii) variable remuneration must be subject to malus or clawback arrangements. However, the requirement to pay variable remuneration in certain instruments and the deferral provision are disapplied for firms whose on and off balance sheet total is less than €100 million. The FCA has suggested in its Discussion Paper that it might increase this threshold for certain types of firm.

Because of the threshold it is likely that these specific provisions will not apply to many private equity and venture capital firms. But investment firms which are not SNIs will still need to review the new rules and implement or update remuneration policies and procedures to reflect these rules. Unless there is further guidance from the FCA there will inevitably be some difficult judgments to be made as to how to apply these rules to private equity and venture capital firms and, in particular, how carried interest should be treated.

Groups

The IFR and IFD also introduce a regime for investment firm groups. Broadly, investment firms which are part of the same group may be subject to consolidated supervision, including the application of group capital and liquidity requirements. Alternatively, where the relevant regulator considers that the group structure is 'sufficiently simple' a group capital test may be applied instead of consolidated supervision.

Whether and how these group rules will apply will depend on the structure of each group. It will also be important to see how the FCA proposes to apply these rules to groups which comprise an investment firm in the UK with a non-UK parent company.

Supervisory review and reporting

The IFD includes provision for an 'internal capital and risk assessment' ("ICARA"). The ICARA is a continuous internal review process to assess and ensure the firm maintains internal capital and liquid assets which are adequate to cover the nature and level of risks the firm poses to others and to which it is exposed. The ICARA is intended to support the firm's management body in its decision-making process and its exercise of oversight and control over the firm. It is effectively a 'pillar 2' requirement, where firms are supposed to determine if the capital and liquid assets they hold as a result of the 'pillar 1' (calculated using the FOR or K-factors) are adequate to address the risks applicable to the firm. Regulators will review the firm's ICARA using a supervisory review and evaluation process ("SREP").

The IFD disapplies the ICARA to SNIs, but permits regulators to decide to apply it to SNIs if they consider it appropriate. In its Discussion Paper, the FCA indicated that it thought it important for all firms, including SNIs, to assess the adequacy of their financial resources to ensure they correspond to the risks presented by, and to, the firm. Consequently, it seems likely that the FCA would apply the ICARA (or a modified version of it) to all firms, including SNIs.

There are also new regulatory reporting requirements that will apply to firms, which will require quarterly reports (annual for SNIs) to be provided to the relevant regulator, covering prudential matters such as the level of composition of regulatory capital, regulatory capital calculations and the data needed to assess whether the firm is an SNI (e.g. balance sheet totals and revenue from investment services).

Transitional provisions

While the IFR and IFD do contain transitional provisions, which are intended to smooth the implementation of the new regime and to avoid firms whose capital requirements will increase having to cover the full increase on day one, there is a gap in the requirements for UK adviser arranger firms that are currently subject to the flat €50,000 requirement. The FCA has acknowledged this gap and has indicated that it will address this in relation to the UK regime.

However, the IFR and IFD transitional provisions appear only to cover the capital requirement. Other aspects of the new rules, such as the liquidity requirements, may not benefit from transitional arrangements. When the UK considers transitional arrangements, it would also be helpful if the arrangements are extended to other aspects of the new rules in addition to the capital requirements (and the BVCA has raised this with the FCA).

Conclusion

The IFR and IFD create a new prudential regime specifically for investment firms. As such they will be as significant for the prudential aspects of investment firm regulation as MiFID II was for conduct and organisational requirements. Certain details of the new regime still remain to be finalised even at EU level, while the FCA must publish its consultation on the rules it will implement in the UK. There is much that still remains to be decided before the rules are final. However, it is likely that the FCA will create a regime that closely follows the EU, and the key implications of that regime are already becoming clear. Even if the final timing for the UK regime is not yet fully confirmed (the UK does not have to implement its rules by 26 June 2021 as EU member states do, and has announced a target date of 1 January 2022 for UK implementation), firms should be considering the EU rules now and assessing the impact of those rules and the changes which they would need to make. These assessments can then be adjusted as necessary when the FCA publishes its detailed proposals.

07.

Sustainable Finance Disclosure Regulation

Tom Taylor (BVCA)

07. Sustainable Finance Disclosure Regulation

Tom Taylor
BVCA

The EU's framework regulation on sustainability-related disclosures in the financial services sector ("SFDR") will apply from 10 March 2021 to EU-regulated AIFMs and MiFID firms, and will also catch non-EU firms marketing funds to EU investors. We reported on the high-level disclosure framework ("level 1") that SFDR establishes for these firms in our Technical Bulletin of May 2019, noting it will require affected firms to make sustainability disclosures on their websites, in pre-contractual information (e.g. PPMs prepared under Article 23 AIFMD) and in periodic reports to investors (e.g. annual reports under Article 22 AIFMD). We also highlighted that much of the detail regarding the content, methodology and presentation of the new sustainability disclosure requirements would be finalised in future regulatory technical standards, or "RTS" ("level 2").

The European Supervisory Authorities consulted on that detail this summer. The level 2 rules that the ESAs proposed were more granular and prescriptive in many areas than most market participants were expecting, and raised a number of concerns. The draft RTS set out, for example, a lengthy and detailed template for firms to disclose their investments' "principal adverse impacts" on society and the environment. Feedback provided to the ESAs by BVCA members (via Invest Europe) argued that it would be difficult or even impossible to obtain data for many of the 32 suggested mandatory sustainability indicators, and suggested the final rules should place much greater emphasis on materiality and proportionality. Members also noted that the 'comply or explain' approach proposed for these adverse impact disclosures could force firms using different approaches to ESG, or partially complying due merely to a lack of data, to make incorrect statements that they took "no consideration" of their investment decisions' impact on society and the environment.

Following a chorus of industry criticism relating to these and other aspects of the proposed rules, amidst a global pandemic and after an official request from the ESAs for more time to finalise the RTS, the European Commission has now indefinitely delayed its implementation of the level 2 measures. Many will have breathed a sigh of relief at this news, given how monumental the task of complying with elements of the proposed RTS by the initial deadline would likely have been. Nonetheless, firms with EU-regulated AIFMs or MiFID firms must continue to prepare to comply with the level 1 rules, as the application date for the high-level SFDR framework remains 10 March 2021.

Broadly, and depending somewhat on how far a particular firm has already embraced ESG practices, we expect private equity and venture capital firms should in principle be able to meet the level 1 website, pre-contractual and periodic disclosure requirements by this date. However, there are areas where the lack of level 1 clarity, which the temporarily absent level 2 measures could have provided, may, in the absence of further guidance from the ESAs, lead to divergences in market practice and supervisory approaches across the EU. The principal grey areas include:

1. **Scope of Article 8 product disclosures**
   The industry argued forcefully in its response to the ESAs consultation that funds with regulatory obligations to disclose sustainability information, or which feature the types of non-material investment exclusion often required by investors in private equity and venture capital funds, should not be deemed to be promoting environmental or social characteristics as a result of those features or obligations, and therefore should not trigger the Article 8 SFDR requirement for additional product level disclosures. As things stand, it is unclear whether Article 8 covers the vast majority of PE/VC funds, or merely a subset of funds that are more actively marketed as being sustainable products. It also remains unclear whether existing PE/VC funds that fall under Article 8, but have already held their final close and are no longer marketing, will be required to make additional website and periodic disclosures, despite the fund manager having included no reference to such disclosures in the relevant pre-contractual statements or fund documentation.

2. **Extent of application to non-EU firms' marketing to EU investors**
   The language of level 1, in isolation, potentially leaves room for different non-EU firms to reach different conclusions on whether marketing to EU investors merely triggers SFDR's product level obligations in respect of the fund being marketed, or alternatively requires the firm itself to comply with the broader entity-level requirements enshrined in the rules, such as those relating to disclosure of the "principal adverse impacts" of the firm's investment decisions, across all its products.

3. **Sub-threshold AIFMs**
   Similarly, it is unclear how, if at all, SFDR applies to sub-threshold AIFMs, given these firms are not specifically dealt with in the SFDR framework, are exempt from the matching AIFMD requirements to prepare annual reports (i.e. periodic disclosures) and PPMs (i.e. pre-contractual disclosures) in a prescribed format, and are more closely connected to domestic rather than pan-EU regulation.

4. **The first SFDR reporting period**
   Firms' obligation to include sustainability information in their annual reports does not apply "until 1 January 2022". It is currently unclear whether this means that the next annual report the firm produces after that date should contain the required sustainability data for the period beginning 10 March 2021, or alternatively that collection of that data is instead required only from 1 January 2022, for inclusion in the annual report to be published in 2023.

These are some of the key areas on which firms and regulators may have to take a view due to a lack of clarity in respect of specific aspects of the EU framework. There are other more general questions relating to the SFDR framework that firms will have to consider, beyond the uncertainties above and how to comply with the EU rules as they stand. For example, given the fact that SFDR has not been transposed into UK law (or 'onshored') because it applies only after the end of the Brexit transition period, along with the UK Government's stated commitment to focusing on the Recommendations of the G20's Taskforce on Climate-related Financial Disclosures (TCFD), firms with UK-only or both UK and EU operations will need to monitor the extent to which different rules in the UK may require different systems and approaches to ESG disclosures for the UK elements of their businesses.

Another, more strategic question for firms with less than 500 employees is whether to opt out of the SFDR framework's requirement to make an annual "principal adverse impact" statement. This will depend to a degree on whether the delayed level 2 rules are ultimately as extensive, prescriptive and burdensome as the draft RTS consulted on this summer suggested they might be. However, in a commercial environment trending already towards greater consideration and disclosure of ESG issues, this could ultimately remain a question of investor preference.

In any case, the sustainability disclosure requirements established in SFDR's level 1 framework will apply to EU-regulated firms and non-EU firms marketing to EU investors from 10 March 2021, and those firms should be preparing to comply with them.

08.

Corporate Transparency & Register Reform

Victoria Sigeti (Freshfields)

08. Corporate Transparency & Register Reform

Corporate transparency and register reform

Victoria Sigeti
Freshfields

In last November's Technical Bulletin, we outlined the key elements of the government's Corporate Transparency and Register Reform consultation (the ***Consultation***) and the BVCA's response to it. By way of recap, the Consultation covered a range of proposals designed to enhance the role of Companies House, increase the transparency of UK corporate entities and help combat economic crime. Certain of these were of more relevance than others to the private equity and venture capital industry. These included:

- Verification of the identity of directors before they could be validly appointed;
- Collection of more detailed information about shareholders;
- Companies House having more discretion to query information on the register; and
- Capping the number of directorships that could be held by an individual.

The BVCA provided a detailed written response to the Consultation[6] and also attended a stakeholder roundtable with representatives from the Department for Business, Energy and Industrial Strategy (BEIS). In addition to specific feedback on each of the key proposals, the BVCA's overriding view was that certain of the proposals seemed disproportionate to the risks outlined in the Consultation and that, if those proposals were implemented in the form suggested, there would be a risk that investors may favour other jurisdictions for their corporate structures.

The government received in excess of 1,300 responses to the Consultation and, in late September 2020, published its response. This update focuses specifically on the government's feedback and the anticipated next steps in relation to the four areas outlined above.

Verification of the identity of directors

The Consultation proposed that a person should not be able to act as a director until his/her identity has been verified.

In the BVCA's response, we expressed concern that there would be a number of complexities in the practical implementation of this proposal. In particular, we considered that it would be difficult to implement in relation to new appointments to existing companies since directors are typically appointed by the board or shareholders and registration is not currently a pre-requisite to being appointed. We envisaged a number of difficulties with changing the law to provide that a director is only validly appointed once registered and verified. In particular, the precise timing of appointment and resignation of directors is critical to ensure a proper allocation of responsibility and liability so any such change would require both identity verification and online registration of appointments / resignations to be able to occur instantaneously (24 hours a day, seven days a week, including for non-UK passport holders). We also expressed concern about the risk of a rise in de facto directors and potential legal uncertainty if existing directors were subject to mandatory verification post-appointment.

Despite the BVCA's reservations, the government received strong support for this proposal and intends to press ahead with it. It acknowledges the need for the verification process to be straightforward, low-cost and quick and proposes to engage with the BVCA and other stakeholders as the precise proposals are developed, to ensure that both the legal framework and the identity

[6] Link to go here

verification system provide the legal and commercial certainty that is required, both in respect of existing and new directors.

The Consultation proposed that individuals who have a key role in companies, such as PSCs, should also have their identities verified. It also considered whether more information should be disclosed about shareholders, including possible identity verification.

In the BVCA's response, we explained that our strong view was that identity verification for PSCs should be voluntary. We also questioned how identity verification could take place prior to a PSC becoming a PSC, since this would have far reaching consequences for M&A and capital markets transactions (such as increasing the leak risk and the introduction of uncertainty through the need for conditionality in transactions).

The government is now pressing ahead with the requirement for identity verification for PSCs but acknowledges that this will need to be after the fact and also that it must be the responsibility of the PSCs themselves rather than the directors.

As regards shareholders more generally, the BVCA's view was that the introduction of identity verification would be disproportionately burdensome and we believed that it would not assist with genuine transparency, since it could only ever relate to legal ownership so could be avoided by those wishing to avoid transparency by the use of nominee structures. The government has acknowledged this issue and, in light of the feedback received, is not proceeding with this aspect of the proposal.

Companies House having more discretion to query information on the register

The Consultation proposed an extension of the powers of Companies House to query and seek corroboration of information before it is entered on the register and to make it easier to remove inaccurate information from the register.

In the BVCA's response, we explained that a general discretion to query information before it is entered on to the register (beyond the discretion Companies House has today to reject an incomplete filing) seemed to us to go too far and to create material uncertainty for companies. This was particularly of concern where it could cause delay on a new incorporation or in circumstances in which there are either legal consequences of a failure to file on time (such as accounts) or for filings which are effective upon registration (such as reductions of capital). We also noted that this approach would also require significant skilled resource at Companies House.

Notwithstanding these concerns, the government has decided to proceed with this proposal. It is, however, conscious of the concerns raised about ease of incorporating companies and doing business and will consult further on the detailed scope of the new querying power and on how its parameters be framed and given effect.

Capping the number of directorships that can be held by an individual

The Consultation sought views on whether imposing a limit on the number of directorships to be held by one individual might deter abuse of UK legal entities.

In the BVCA's response, we disagreed with the introduction of a cap as we thought it would be arbitrary. We also noted that the introduction of a cap could lead to less experienced individuals being required to take on directorships, which in the context of the drive towards high quality corporate governance, would be an unfortunate outcome.

In light of the feedback received, the government has decided not to proceed with this proposal.

Next steps

The government intends to launch a further consultation to help it develop and arrive at more detailed proposals in the areas which are being taken forward. The BVCA is looking forward to engaging with BEIS to input into the formulation of these proposals.

09.

Case Law update

Geoffrey Kittredge, Richard Lawton and John Young (Debevoise & Plimpton)

09. Case Law update

Commercial Court gives guidance on construction of "material adverse effect" clause in share purchase agreement in the wake of Covid-19 pandemic

Geoffrey Kittredge
Debevoise & Plimpton

Richard Lawton
Debevoise & Plimpton

John Young
Debevoise & Plimpton

Travelport Ltd & Others v WEX Inc [2020] EWHC 2670

A decision on preliminary issues by the Commercial Court sheds light on a number of important points on the wording and interpretation of "Material Adverse Effect" clauses in share purchase agreements. WEX Inc ("**WEX**") had agreed to purchase eNett International (Jersey) Limited ("**eNett**") and Optal Limited ("**Optal**"), two business-to-business ("**B2B**") payments companies, specialising in the travel sector. The two parties signed the share purchase agreement ("**SPA**") on 24 January 2020. One of the conditions precedent to closing of the transaction was that there had been no Material Adverse Effect ("**MAE**") since the date of signing. The MAE clause included a carve-out (among other instances) for "conditions resulting from…pandemics", which would prevent operation of the clause. There was an exception to that carve out if the MAE had "a disproportionate effect" on each of the target companies "taken as a whole, as compared to other participants in the industries in which [they] operate". Therefore, if conditions resulting from the pandemic caused a disproportionate effect on either the eNett or Optal Groups, each taken as a whole, as compared to other participants in the industries in which they operate, the conditions would constitute a MAE, entitling WEX to avoid closing the acquisition.

In May 2020 WEX notified the selling shareholders that, due to the effects of the Covid-19 pandemic, a MAE had occurred pursuant to the SPA and that it was not obliged to close the transaction.

The selling shareholders (the "**Sellers**") denied that there had been a MAE pursuant to the SPA and issued claims against WEX in the Commercial Court seeking a declaration that there had been no MAE pursuant to the Agreement and specific performance of WEX's obligation to complete the transaction.

Following an expedited hearing, the Commercial Court issued its decision on a number of crucial preliminary issues on 12 October 2020.

The Court focussed on the construction of the exception to the carve-out and, in particular, the meaning of the word "industry", used to determine whether the pandemic had a "disproportionate affect" on eNett or Optal. The Sellers contended that eNett's and Optal's financial condition should be compared against the travel payments industry (which had of course been widely affected by the pandemic, but with arguably no disproportionate effect on eNett or Optal), whereas WEX argued that it should be measured against the broader B2B payments industry (which had not been widely affected by the pandemic, although with disproportionate effect on eNett and Optal).

The judge, Cockerill J., accepted that the relevant industry against which eNett and Optal's position should be compared for purposes of the MAE clause was the broader B2B payments industry, finding that there was no "travel payments industry" as the Claimants had asserted. In this regard, it was important that the parties used "industries" as the comparator, not "markets", "sectors" or "competitors", or an "identified pool" of businesses. Cockerill J. found that industry was "broader" and captured "a group of participants in a broad sphere of economic activity". While accepting that the wording of the MAE was a "common exception" that was "probably largely taken from a pro forma", she noted that the SPA was a highly negotiated text drafted by lawyers and that "industry" could be taken to have a formal and precise meaning.

Cockerill J. took into account expert testimony (such as whether the companies provided B2B payment products specifically suited to the travel industry) and statements the parties had made during negotiations in "outward facing" documentation, including investor presentations, in order to determine whether the parties stated that they were buying or selling a travel payments business or a payments business. In finding that the relevant industry was the B2B payments industry, the judge also placed some weight on the statements the parties had made to competition authorities, where they referred to the B2B payments segment.

While WEX relied primarily on the “ordinary and natural” meaning of the MAE clause, the Sellers argued that the commercial purpose was critical, contending that the MAE clause should be interpreted according to its objective purpose in the transaction, which was to isolate “firm specific risks” from “systemic risks”. The judge ultimately rejected this argument, finding that the transaction was not exclusively to purchase a travel payments business, as the parties also had other markets in contemplation. In any case, the clear meaning of the words in the contract could not be displaced by such an interpretation.

Cockerill J. found “a dearth of relevant English authority” dealing with MAE clauses in share purchase agreements and allowed consideration of US authorities, in particular those of the Delaware Court of Chancery, which she described as a “leading forum” for the consideration of MAE clauses. The Sellers based their analysis of the “commercial purpose” of the agreement and the distinction of firm specific and systemic risks on the Delaware case of *Akorn Inc. v Fresenius Kabi AG*. Importantly, however, Cockerill J. stated that the proper construction of MAE clauses will always depend on their precise wording and that the principles that can be derived from US authorities cannot displace the careful reading and drafting of each clause.

Supreme Court considers ‘reflective loss’ principle in new landmark case on asset-stripping

Sevilleja v Marex Financial Ltd [2020] UKSC 31

The facts in the appeal to the Supreme Court were as follows. Mr Sevilleja owned and controlled two companies incorporated in the British Virgin Islands (the “**Companies**”) which he used as vehicles for trading in foreign exchange. His broker, Marex Financial Ltd (“**Marex**”), had obtained a judgment debt against the Companies in the Commercial Court for about $5.5 million and was awarded costs which were later agreed at £1.65m.

After the draft judgment was issued to the parties, but before it was made public, Mr Sevilleja moved funds from the Companies into his personal control, leaving insufficient assets to repay the debt to Marex. The Companies were subsequently placed into insolvent voluntary liquidation. Marex sought damages in tort on two grounds. Firstly, that Mr Sevilleja had induced or procured the violation of Marex’s rights under the judgment and, secondly, that Mr Sevilleja had intentionally caused the Companies to suffer loss by unlawful means. The issue which the court had to resolve was whether Marex, a creditor of the Companies, could claim against Mr Sevilleja, a third party, who had asset-stripped the Companies, or whether Marex’s claims were barred by the fact that the Companies were the proper plaintiffs to such an action.

It was Mr Sevilleja’s claim that certain of the amounts Marex claimed against him were unrecoverable due to the “no reflective loss” principle. This principle prevents shareholders from seeking recovery against a defendant for losses caused by wrongdoing in respect of which the company also has a claim. Under Mr Sevilleja’s counsel’s argument, it was for the creditors to claim against the Companies and for the Companies (or their liquidator) to claim against Mr Sevilleja, precluding a direct claim by the creditors against Mr Sevilleja.

On appeal at the Supreme Court, the Supreme Court held that Marex’s claim was not barred by the “no reflective loss” principle. On this issue, the Supreme Court held unanimously that the reflective loss principle applies only to claims by shareholders (which, as a result of loss suffered by their company, the value of their shares, or of the distributions they receive as shareholders, has been diminished), not claims by creditors. As a result, Marex's claim was not limited by the reflective loss principle and it was permitted to pursue its claim. The decision reinstates creditors' ability to bring claims against wrongdoers (such as shareholders) whose actions have diminished a company's financial position, and is of particular relevance to companies in financial difficulty due to the pandemic.

FCA test case on business interruption claims in wake of Covid-19 pandemic

Financial Conduct Authority v Arch Insurance (UK) Ltd [2020] EWHC 2448 (Comm)

The FCA applied to the High Court for declarations to resolve the uncertainty in the interpretation of business interruption policies in the wake of the Covid-19 pandemic. The High Court assessed the policy coverage under various specimen wordings underwritten by eight defendant insurers for claims arising out of the pandemic, and the public advice and restrictions the UK government introduced in response. The court examined 21 policy wordings, which, according to the FCA, could affect 700 types of policies, 60 insurers, 370,000 policyholders and "billions" in claims.

The FCA argued that cover should be available if the business interruption loss was generally caused by Covid-19, regardless of any detection of Covid-19 within a certain radius from the insured premises. It further maintained that government restrictions also triggered coverage, as they prevented businesses from operating as usual.

The defendant insurers argued that only local detection of Covid-19 triggered coverage under the wordings. With regard to government actions, they argued that only mandatory orders would trigger coverage, whilst advice or guidance would not.

The FCA, six insurers and an action group have filed "leapfrog" appeals to the Supreme Court, which will consider them in a four-day hearing due to start on November 16. In broad terms, the High Court accepted the FCA's general categorisation of coverage wordings and provided guidance on various types of Clauses in insurance contracts, in particular "Disease" clauses and "Prevention of Access" clauses.

Disease Clauses

These clauses cover, in broad terms, business interruption "in consequence of or following or arising from the occurrence of a notifiable disease within a specified radius of the insured premises." The High Court held that the sample policy wordings did not only cover a local occurrence of disease. As they did not expressly state that the disease should occur *exclusively* within the relevant area, the insured risk was a disease that can occur nationwide. Examining the purpose behind the coverage, the Court found that the nature of diseases such as Covid-19 is they "may very well spread over a significant, and difficult to predict, area" and "produce a response from the authorities or the public which is to the outbreak as a whole, not to those parts of it which fall within 'the Vicinity'." Siding with the FCA, the court held that individual outbreaks of diseases such as Covid-19 are not separate from the general spread.

Prevention of Access Clauses

These clauses cover cases "where there has been a prevention or hindrance of access to or use of the premises as a consequence of government or local authority action or restriction." The Court construed these clauses more narrowly than the diseases clauses. Whether these policies provided cover would depend on the actual policy wording and the specific application of government advice or mandatory rules on the policyholder's business. The term "interruption" should not be limited to complete cessation, but includes "disruption to or interference with the business".

Causation

In a significant victory for policyholders, the Court found that it was generally not necessary for the policyholder to demonstrate a direct proximate cause for each loss suffered. According to the court, the occurrence of Covid-19 in a relevant policy area should be treated as a single cause of business interruption (whether relating to the outbreak itself or the subsequent governmental reaction). The insurers had argued that the insured peril covered a specific occurrence of Covid-19, "but for" which the loss would not have occurred. While the outcome for policyholders will depend on the precise wording of their cover, the Court found that this "but for" test should be applied to "the entire chain of events, including the occurrence of the disease" rather than each specific occurrence of it. The proper "counterfactual" position, i.e. what the insured's position would have been "but for" the insured peril's occurrence, was "a world in which all the elements of the insured peril did not exist". The defendant insurers had argued that the insured peril should be defined narrowly, relying on the decision in *Orient Express Hotels Ltd v. Assicurazioni Generali SpA* [2010] EWHC 1186 (Comm). The Court, however, criticised the *Orient Express* judgment and distinguished it from the present case on construction, on the ground it dealt with an "all risks" cover, not a composite peril cover.

Covid-19 and winding up petitions following the Corporate Insolvency and Governance Act 2020

Re A Company (Injunction to Restrain Presentation of Petition) [2020] EWHC 1406 (Ch)

The High Court restrained the presentation of a winding-up petition against a tenant which had defaulted on its rent due to the Covid-19 pandemic. This judgment follows the earlier judgment of *Travelodge Hotels Ltd v Prime Aesthetics Ltd* [2020] EWHC 1217 (Ch).

The petitioner, a High Street retailer, had been forced to suspend trading due to the pandemic and became unable to pay its rent. As the landlord was prevented from seeking forfeiture of the lease due to the Coronavirus Act 2020, it served a statutory demand relating to the arrears of rent and sought the winding up of the company. The retailer sought an injunction on a number of grounds, notably on the strength of the Corporate Insolvency and Governance Bill (as it was then) 2020, despite that Bill not yet being law.

The Corporate Insolvency and Governance Act 2020 ("**CIGA 2020**"), which received Royal Assent on 25 June 2020, made some time-limited measures designed to assist companies affected by the pandemic. One of these measures was a temporary prohibition on the presentation of winding up petitions by creditors. A creditor can avoid the prohibition only if it can demonstrate reasonable grounds for believing that "coronavirus has not had a financial effect on the company, or the facts by reference to which the relevant ground [to petition for the winding up] applies would have arisen even if coronavirus had not had a financial effect on the company". This restriction applied retrospectively to any winding up petitions brought between 27 April 2020 and 30 September 2020.

Injunctions to restrain a winding up petition are usually sought on the grounds of disputing the debt. The judgments in *Re A Company and Travelodge* both granted injunctions on the basis of the effect of coronavirus, relying on CIGA 2020, finding that the virus had an effect on the respective companies, and that, absent the pandemic, the facts supporting the petition would not have arisen. Both judgments stated that the draft bill, which represented a highly likely and imminent change in legislation (with retrospective effect), should be taken into account and found that the winding up petitions constituted an abuse of process.

The case also shows the difficulty creditors will have in presenting winding up petitions in light of the protections given to companies in difficulty in CIGA 2020. It will not be easy for a creditor to argue a petition which does not meet the stringent condition set out in the Act – that the facts on which the petition is based would have arisen even if coronavirus had not had a financial effect on the company.

The authors gratefully acknowledge the contributions of Yannis Paradeisiadis to this article.

British
Private Equity &
Venture Capital
Association

**British Private Equity &
Venture Capital Association (BVCA)**

5th Floor East, Chancery House
53-64 Chancery Lane
London WC2A 1QS

T. +44 (0)20 7492 0400
E. bvca@bvca.co.uk

www.bvca.co.uk