Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels | London

August 14, 2023

Via Electronic Submission: dpt-tp-pe-reform@hmrc.gov.uk

HM Revenue and Customs
100 Parliament Street
Westminster
London
SW1A 2BQ
United Kingdom

Re: Reform of UK law in relation to transfer pricing, permanent establishment and Diverted Profits Tax

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to provide feedback to His Majesty's Revenue and Customs' ("**HMRC**" or "**HM Revenue & Customs**") consultation on the reform of UK law in relation to transfer pricing, permanent establishment ("**PE**") and diverted profits tax ("**DPT**"), published on 19 June 2023 (the "**Consultation**").[2]

Our responses below reflect the legal and commercial issues that our members have encountered relevant to the areas of transfer pricing, PE and DPT. Accordingly, we have not responded to every question posed in the Consultation but have commented on certain issues and concerns relating to the proposed updates to the definition of a UK PE (in the context of the asset management industry), as well as offering broader feedback on aspects of the transfer pricing and DPT proposals.

While we generally welcome HMRC's desire to simplify the operation of the UK tax code and keep pace with evolving international standards, we consider that certain of the changes proposed in the Consultation could represent very significant developments for our members. As a general principle, any such changes should be effected only to the extent necessary and should be made through enacting legislation upon which stakeholders have been given a meaningful opportunity to engage and comment.

Specifically, we are concerned that the proposed changes to the UK definition of a PE will not meaningfully clarify or improve the existing position for asset managers and may render many existing arrangements involving UK investment advisory or investment management functions more difficult to operate in practice, with no clear operational or compliance benefit. To mitigate these concerns, we strongly support, and offer options for, specific legislative protection for UK-managed fund structures.

We generally support the transfer pricing and DPT elements of the Consultation that simplify existing rules and reduce the compliance burden on UK taxpayers.

---

[1] Managed Funds Association ("**MFA**"), based in Washington, D.C., New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 170 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage nearly $2.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

[2] "Reform of UK law in relation to transfer pricing, permanent establishment and Diverted Profits Tax," HMRC, https://www.gov.uk/government/consultations/uk-law-reform-in-transfer-pricing-permanent-establishment-and-diverted-profits-tax/reform-of-uk-law-in-relation-to-transfer-pricing-permanent-establishment-and-diverted-profits-tax (published 19 June 2023).

Transfer Pricing

Our members are generally in favour of changes that reduce the compliance burden on UK taxpayers, a key component of which is legislative certainty. Our substantive observations in relation to the transfer pricing elements of the Consultation are as follows.

Provision[3]

We welcome the proposal to replace the term "provision" in the UK domestic transfer pricing legislation with reference to "conditions," consistent with the approach taken by Article 9(1) the 2017 OECD Model Tax Convention on Income and Capital ("**OECD Model**"). The OECD Model represents the intent of the UK rules (in line with the explanatory note to the introducing legislation) and will ensure greater clarity in applying the UK legislation.

Participation Condition[4]

We strongly urge that any amendment to the "participation condition" should be effected (if at all) only insofar as the scope of that condition remains clear and objective on the face of the resulting UK domestic legislation. It is generally well understood whether the UK transfer pricing rules are engaged by the existing participation condition, and we are not aware of common circumstances in which the structuring of our members' UK operations is premised on any fringe interpretation of the participation condition. If this threshold condition were expanded to include new "non-exhaustive" concepts (equivalent to the non-UK examples given of "acting in concert" or "community of interest") or were premised on a more subjective causality test (in line with the Swiss approach described in the Consultation), such an amendment would risk introducing significant uncertainty and cost for our members' tax compliance processes.

Domestic Transfer Pricing[5]

We strongly support the creation of an exemption from the UK transfer pricing rules with respect to purely domestic UK arrangements. Specifically, we would favour a general exemption for domestic-to-domestic transactions (with limited carve-outs to protect the UK tax base in specific circumstances) to ensure that this exemption is simple to apply and can readily deliver for taxpayers the reduction in compliance costs which will be the true measure of its success.

Other Transfer Pricing Issues

As the representative body of the global alternative asset management industry, we are aware that certain members of our industry have experienced increased HMRC focus (through the lens of transfer pricing) on generally accepted and very prevalent positions regarding the absence of management fees on "inside capital" (*i.e.*, co-investment into funds by the asset management executive team). Third-party investors almost universally require asset management teams to invest a certain amount of their own money into their funds to ensure alignment of interests with investors, but the widely accepted industry view (including from third-party investors) is that the managers should not be

[3] ***Consultation Question 1:*** "The government welcomes respondents' views on the term 'provision' within s. 147 TIOPA 10. Specifically, is this term commonly understood, does it provide anything more than 'conditions' per Article 9 of the OECD Model, and do respondents encounter any practical difficulties which result from the difference in terminology between UK domestic law and the Treaty?"

[4] ***Consultation Question 2:*** "The government welcomes respondents' views on the participation condition, and experiences of the application of other jurisdictions' laws in that regard."

[5] ***Consultation Question 4:*** "The government requests respondents' views on UK:UK transfer pricing. Is it onerous and to what extent, and would providing a general exemption materially reduce the compliance burden? Do respondents have any views on the practical application of a general vs specific exception to the general exemption?"

required to charge themselves a management fee on their own capital. Investors want to ensure they are getting the best possible management advice by requiring their managers to have "skin in the game" (*i.e.*, for the manager to be invested alongside the third-party investors).

In this context, third-party investors do not expect or require the managers to charge themselves a management fee; the existence of the "inside capital" is (in and of itself) sufficient. Most third-party investors will require this "inside capital" as a precondition to secure their investment and to justify the arm's length management fee paid to the UK manager. It is not apparent that the terms of the Consultation will directly consider this issue, but we would welcome any endeavours to clarify UK transfer pricing rules to reflect this widely accepted industry view in any forthcoming amendments to UK domestic transfer pricing legislation.

Permanent Establishment

Concept

While we generally support the notion that alignment between UK domestic legislation and international OECD principles can improve certainty for UK taxpayers, we are concerned that the proposed changes to the UK definition of a PE will not meaningfully clarify or improve the existing position for asset managers and may render many existing arrangements involving UK investment advisory or investment management functions more difficult to operate in practice. Such changes could, with no clear operational benefit to our members, result in pre-existing structures, which have in many cases operated successfully in the UK for a number of years (contributing significantly to the UK economy), needing to be re-assessed. This sort of change sits uneasily with the many welcome efforts that have been made by His Majesty's Treasury and HMRC in recent years to attract greater asset management activity into the UK. Our more specific concerns with the Consultation proposals relating to the PE definition are explained below.

Interaction with Income Tax Charge

While the Consultation document considers the reform of the UK corporation tax PE legislation, it does not cover the corresponding income tax rules. Specifically, our members are strongly of the view that there is a need to simplify the potential UK tax that can be charged on non-resident bodies corporate by subjecting all entities of this type to a single set of rules. The technical income tax charge which can arise under Part 2 of the Income Tax (Trading and Other Income) Act 2005, where treaty relief is not otherwise available (which is the case for many of our members established in jurisdictions without double taxation treaties with the UK), creates unnecessary complexity and confusion when navigating the UK's tax rules. The UK should adopt a single set of rules applicable to non-resident bodies corporate which make it clear whether a charge to UK tax arises (be it income tax or corporation tax). We note that a similar simplification approach has recently been taken to capital gains tax through the introduction of Section 5(5) Corporation Tax Act 2009 and Sections 1(2) and 2B of the Taxation of Chargeable Gains Act 1992 which make clear that companies are subject to corporation tax on chargeable gains only (regardless of residence). We strongly urge that this issue is addressed as part of this Consultation as it would increase the attractiveness of the UK for non-UK investors as a jurisdiction in which to do business, without affecting the UK's tax revenue.

*Agent of Independent Status ("**AIS**") Exclusion*[6]

We have identified adverse, unintended consequences specific to the asset management industry that may arise from the proposed changes with respect to existing UK investment advisory and investment management arrangements commonly implemented by our members. In light of the UK

[6] ***Consultation Question 22:*** "The government welcomes comments from respondents on the potential impact of the reforms contemplated in this consultation on the UK asset management sector."

government's record of seeking to support and attract fund managers, these consequences merit special consideration and may require specific legislative carve-outs to the extent changes to the UK definition of a PE are effected as currently proposed. Specifically, if the overall intention is to maintain the current scope of application of the investment manager exemption ("**IME**") and avoid adversely affecting the ability of UK asset management functions to rely on the AIS Exclusion (as defined below, whether in an applicable double tax treaty or under UK domestic law) as an alternative, we strongly urge attention to these consequences and adoption of potential legislative solutions discussed more fully under the headings below.

For context, a significant number of our members operate UK structures that primarily rely on being an agent of independent status (the "**AIS Exclusion**") to prevent the creation of a taxable dependent agent PE (per Section 1142 of the Corporation Tax Act 2010 ("**CTA 2010**")), rather than directly relying on the IME (per Section 1146 of CTA 2010). This is commonly the case for fund structures in which there is an onshore UK advisor or sub-advisor entity, the role of which is to provide deal origination, deal process support, investment monitoring and investment and divestment advice or recommendations, but which does ***not*** have discretionary investment management powers (*i.e.*, does not have authority to directly act on behalf of or execute or dispose of investments on behalf of the offshore fund). This is often the case for funds with less liquid strategies (and which, therefore, have no practical need for direct discretionary management powers in the UK). These funds may well—as a first consideration—not be treated as "trading" for UK tax purposes, but they nonetheless seek to rely on the AIS Exclusion as a back-stop against potential taxation of the offshore fund vehicle through a UK PE.

These structures may satisfy the requirements of the IME, if required. However, on the basis that the analysis required to access the AIS Exclusion in its current form is often more straightforward than the analysis required to establish reliance on the IME, those fund arrangements might not have been structured with the IME conditions in mind and may not (to date) have carried out any formal assessment of how the IME may apply to them. There are also certain structural features of some fund strategies (for example, CLO risk retention funds which commonly feature "horizontal" risk retention, *i.e.*, a disproportionate holding of the most subordinated, equity-like tranches of CLO debt) that can prevent the IME conditions being satisfied in full, even though in other respects the relationship of the onshore UK manager to the offshore vehicle has all the characteristics of an arm's length relationship to which the IME might otherwise be expected to apply. Such funds also commonly rely on the AIS Exclusion in its current form.

If, therefore, the Consultation's proposed updates to the definition of a PE could result in denying existing UK fund management entities the ability to rely on the AIS Exclusion, such updates would likely require funds to undertake additional IME analysis and, potentially, consider a restructure where the relevant IME conditions cannot be met.

For completeness, we note that the onshore UK advisors or sub-advisors in those structures that currently rely on the AIS Exclusion almost universally receive an arm's length advisory fee subject to taxation in the UK. Accordingly, the integrity of the current UK tax base with respect to the value of activity actually taking place in the UK should be sufficiently protected without running the risk of the offshore fund vehicles themselves acquiring a taxable PE in the UK. Such a risk would not be acceptable to investors, and most asset managers would find themselves needing to reconsider their UK operations—in part, pursuant to binding, contractual obligations to their investors—if any legislative changes around the PE definition were to expose the offshore funds (or their investors) to an increased risk of acquiring their own taxable PE in the UK.[7]

[7] ***Consultation Question 21:*** "The government also welcomes any specific additions, exceptions or exemptions which respondents deem helpful to identify or add in at this stage."

As further background, we note that, in the context of UK corporate tax residence, it is very clear from Section 363A of Taxation (International and Other Provisions) Act 2010 that qualifying non-UK corporate funds should be protected from becoming UK tax residents only by reason of their "management and control" being exercised from the UK. It would be a very surprising and inequitable result if corporate funds that qualified for this safe harbour were no longer able to enjoy at least equivalent protections with respect to UK PE risk. Nor would it make sense for such protections to extend only to funds that take a corporate form as investors in partnership funds are especially sensitive to UK PE risk as it relates to their own tax position on a flow-through basis. While our preference would be for the UK definition of a PE to remain unchanged or, at the very least, for the current scope of the AIS Exclusion not to be narrowed, we would, in the alternative, strongly encourage HMRC to consider some broad exceptions from any new (broader) definition of a UK PE for qualifying funds, on a basis generally consistent with the approach taken for corporate tax residence purposes.

Inclusion of persons who "habitually play the principal role leading to the conclusion of contracts that are routinely concluded without modification by the enterprise" as dependent agent PEs[8]

This proposed change to the UK definition of a dependent agent PE is likely to mean that typical UK onshore advisor structures (as described above) are *prima facie* brought within the scope of a dependent agent PE. In these structures, the non-UK manager or general partner of the offshore fund has the ability and authority to, but does not commonly in practice, make material changes to contracts that have been substantially negotiated by the UK onshore advisor or sub-advisor's personnel. The UK advisor's role in sourcing and negotiating these investment contracts forms an essential part of its comprehensive investment advisory services for which it is remunerated on an arm's length basis. In other words, the key functions—exercised as part of the onshore UK investment advisory business—leading to agreement on the terms of such contracts have already been remunerated and taxed in the UK, including, in many cases, through being outsourced to third-party UK service providers. It would be disproportionate to expose the offshore fund or its investors to UK tax risk, including compliance and reporting consequences, in respect of the wider investment portfolio (which may or may not relate to the UK) only by reason of the investment advisory functions being performed in the UK.

Narrowing the AIS Exclusion to exclude a person who "acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related"[9]

Where an onshore UK manager or advisor/sub-advisor does not satisfy the conditions of the IME and "acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related," such an entity would, under the Consultation's proposed changes, be unable to rely on the AIS Exclusion and may, therefore, constitute a UK taxable PE of the offshore fund (or its investors), absent other facts which may lead to a different conclusion.

Making this change as currently envisaged by the Consultation would have the immediate consequence of expanding the technical analysis required by funds and their managers to determine whether the IME applies when establishing and maintaining fund structures that involve a UK-based manager or advisor/sub-advisor. This expanded technical analysis would create additional friction in the fund formation process and discourage funds from establishing or maintaining their management operations in the UK as compared to certain other jurisdictions.

[8] ***Consultation Question 15:*** "Do respondents foresee any issues with the UK limiting this definition to fixed place of business and dependent agent PEs?"

[9] ***Consultation Question 16:*** "Do respondents foresee any specific issues with the UK changing its domestic law position in terms of the definition of a dependent agent PE? Do respondents foresee any specific issues with the UK changing its domestic law position in terms of the definition of an independent agent?"

There are also circumstances in which the relationship between a UK manager or advisor/sub-advisor and offshore fund may not meet every requirement of the IME. It would be illogical and distortive to prevent reliance being placed on the AIS Exclusion solely on the basis that the UK entity acts only for "closely related" funds. It is also notable that the IME itself does not rely on this same concept of "closely related" funds.

Compare, for example, a UK onshore investment manager acting exclusively for non-UK entities that are ultimately under common control (and presumptively would be caught within the meaning of "closely related"), with a co-investment vehicle which is predominantly funded by proprietary capital (*i.e.*, "inside-capital") (an "**Inside Co-Invest Vehicle**"). The IME may well apply to the UK manager's relationships with the "closely related" funds, the investment capital of which comes from third parties. By contrast, the independent capacity test (Condition C)[10] of the IME may be failed (or, at least, the safe harbours within the independent capacity test may not be satisfied) with respect to the Inside Co-Invest Vehicle.

If the Consultation changes were effected as currently proposed, the UK manager would no longer be able to rely on the AIS Exclusion in the latter scenario. As a result, the Inside Co-Invest Vehicle would have a very different risk profile from a UK taxable PE perspective than the equivalent third-party capital fund vehicles, despite the functional relationship between the UK manager and the Inside Co-Invest Vehicle (*i.e.*, what the UK manager actually does for the offshore entities) being the same as that between the UK manager and the third-party capital fund vehicles (save, potentially, with respect to fees). Such an inequitable result appears contrary to the cohesive functioning of the PE regime and the UK government's policy of supporting and attracting fund managers and greater asset management activity into the UK.

To the extent the Consultation proposals relating to PEs are pursued further, to mitigate this sort of issue, we strongly support specific legislative protection for UK-managed fund structures. Specifically, we strongly prefer a legislative approach that disapplies the narrowing of the AIS Exclusion, either: (1) in its entirety in circumstances where the person in question is a fund manager as determined by reference to Condition A of the IME ("**Option 1**"),[11] or (2) in circumstances where the person in question is a fund manager (also to be determined by reference to Condition A of the IME)[12] that acts exclusively or almost exclusively on behalf of enterprises to which it is closely related and meets the IME conditions in respect of one or more of those other closely related enterprises (a "**Comparator Fund**") ("**Option 2**").

Option 1 preserves the status quo of funds and managers relying on the AIS Exclusion to creating a UK PE through UK management activities. Accordingly, Option 1 provides the greatest degree of certainty going forward while also imposing the lightest compliance burden on fund managers (which may not otherwise consider the IME in relation to these structures). Option 2 would require fund managers to consider all conditions of the IME in respect of Comparator Funds and may, therefore, significantly increase the compliance burden on these funds that have not previously considered the IME. In any case, respondents to the Consultation should be provided with further opportunity to comment should HMRC choose to pursue any legislative drafting seeking to protect existing UK-managed fund structures (as discussed above), including Option 1 or Option 2.

[10] Section 1146(5) CTA 2010

[11] Section 1146(3) CTA 2010

[12] Section 1146(3) CTA 2010

Approach to Legislation[13]

To the extent the Consultation proposals relating to PEs are pursued further, we believe there is limited practical difference between the two proposed alternatives to implementing the definitional change (option (a) and option (b) in paragraph 4.4 of the Consultation). Both proposed models should result in a relevant double tax treaty applying (where one exists) and the OECD Model applying otherwise. In the interim (or prior to any subsequent consultation), we encourage HMRC to clarify whether there is intended to be any material distinction in the overall application of the proposed new regime as between options (a) and (b) and, if so, the desired practical outcome of each option. If there is a material difference between the two options in HMRC's view, then respondents to the Consultation should be provided with further opportunity to comment.

Subject to such clarification, if these changes are to be pursued, we prefer option (b) (*i.e.*, defining a PE for UK purposes by direct reference to the OECD Model, subject to any relevant double tax treaty) because this approach would provide a common starting point for analysis between the UK and many other jurisdictions and would better align with the general principle that domestic law should be considered first, with a relevant double tax treaty overlay as necessary.

Further, we encourage HMRC to articulate its view as to how future developments in relation to Pillar One of the OECD's Inclusive Framework on Base Erosion and Profit Shifting will affect or be incorporated into the proposed changes to the PE definition. In this regard, we consider that option (b) would result in an easier route to implementing any future Pillar One-related changes to PE definitions in double tax treaties (which we assume would be implemented through a further multilateral convention) by providing a robust baseline consistent with current OECD standards from which the UK can choose to implement Pillar One changes on a case-by-case basis (*e.g.*, by lodging reservations to the implementing multilateral convention).

Diverted Profits Tax

We generally agree with incorporating DPT into the corporation tax charge. In particular, we welcome removal of the avoided PE basis for application of the DPT (*i.e.*, removing Section 86 of Finance Act 2015). Further, we appreciate and value the consequential benefits that would arise because of this change, for example, in the administration of the DPT (returns, assessments, penalties, etc.) and also in clarifying the position with respect to foreign tax credits in non-UK jurisdictions for amounts of UK DPT payable by funds.

* * *

We appreciate the opportunity to submit feedback to HMRC, and we would be pleased to meet with the lead officials for the Consultation to discuss our comments. If the lead officials have questions or comments, please do not hesitate to contact Joseph Schwartz, Director and Counsel, or the undersigned at +001 (202) 730-2600.

Respectfully submitted,

/s/ Jillien Flores

Jillien Flores
Executive Vice President
Head of Global Government Affairs
Managed Funds Association

[13] ***Consultation Question 14:*** "The government welcomes general observations from respondents regarding the perceived advantages and disadvantages of each option for amending the PE definition."