CLIENT ALERT

UK's Multinational Top-Up Tax: Considerations for Asset Managers

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Introduction

The UK has become one of the first countries to issue draft legislation on a new multinational top-up tax (the **top-up tax**) as it continues to support efforts to bring into force the framework for a global minimum tax. The draft legislation incorporates the OECD's model rules on the income inclusion rule (one of the key measures within the OECD's two-pillar solution to reform international tax rules) published in December 2021 (the **Model Rules**) into UK domestic law.

Whilst it is anticipated that investment funds and asset holding companies will generally be outside the scope of the top-up tax, asset managers will still need to consider whether the vehicles they utilise satisfy a number of conditions. As drafted, the top-up tax rules are likely to result in greater complexity in managing the tax affairs of both fund vehicles and portfolio companies.

Background

The Model Rules introduce a framework which requires multinational groups to pay a domestic minimum tax of 15% in each jurisdiction in which they have a taxable presence or face top-up tax charges in the jurisdiction in which the group parent is established. The rules target multinational groups with consolidated annual revenues in excess of €750 million where members of the group are subject to an effective tax rate of less than 15%.

Importantly, the rules were not intended to adversely impact the tax-neutral status of investment fund vehicles. However, without explicit exclusions, typical investment fund structures are still capable of being caught – even where existing domestic law would otherwise regard these entities as transparent for tax purposes. Certain investment vehicles could, therefore, face the administrative burden of complying with these rules and/or risk being required to apply the top-up tax rules to underlying investments. Going forwards, asset managers should ensure their investment vehicles fall outside the scope of the top-up tax (whether by virtue of an express exclusion or otherwise).

Exclusion for investment funds

As a starting point, a fund will not be treated as the group parent of a multinational group, and therefore will not need to comply with the top-up tax rules, unless it produces consolidated accounts. However, even where a fund is not the group parent, it will still be important to consider whether the fund is an excluded entity when assessing the application of the top-up tax to asset holding companies, which is more likely to meet the definition of a group parent. As discussed in more detail below, whether an asset holding company is an excluded entity will depend on whether it is owned by an excluded entity (or entities).

An "investment fund" is, amongst others, an excluded entity for the purposes of the top-up tax and an "investment fund" is defined as an entity that:

1. is designed to pool assets from multiple investors, some of which must be unconnected;
2. invests according to a defined policy;
3. operates with a view to either reduce transaction and research costs, or spread risk;
4. is primarily designed to either generate investment income or gains, or hedge against particular or market risks;
5. provides investors with rights to the fund's assets based on their contributions;
6. is subject to a regulatory regime (including anti-money laundering and investor protection regulations); and
7. is managed by an investment management professional.

Whilst these conditions provide a clear framework for the types of investment funds that should be excluded from the multinational top-up tax, there remains uncertainty as to the interpretation of several aspects. Although the OECD's commentary to the Model Rules (the **Commentary**) may assist with this interpretation, the Commentary is not complete and will require asset managers to assess these conditions on a case-by-case basis.

Initial areas for consideration

Whilst a detailed analysis of all the conditions of an “investment fund” under the new multinational top-up tax rules is beyond the scope of this note, we have set out below some of the more interesting points which asset managers should consider.

Designed to pool assets from a number of investors

Pooling assets from a number of investors is one of the primary functions of asset management; however, there are circumstances where a fund may struggle to show it pools assets – such as during the initial offering period or during a liquidation process – but a fund should satisfy the test in such circumstances where it has been “designed” to do so. This does not, however, alleviate the potential pitfalls for single-investor funds (funds-of-one) (including single-investor funds utilised in a parallel fund structure).

Accordingly, managers should take measures to evidence that they have sufficiently marketed the fund to prospective investors and contemplated attracting multiple investors. In the case of funds-of-one, it may be more difficult to evidence this condition and it remains to be seen whether HMRC or the OECD will issue further guidance on the application of this condition for single-investor funds (whether utilised in a parallel fund structure or otherwise).

A defined investment policy

Defined investment policies (or guidelines) are commonly included when a fund is offered to prospective investors. However, it remains to be seen at this stage in the development of the rules how strictly HMRC will interpret this requirement. Best practice, therefore, dictates that a defined investment policy should: (i) be determined and fixed prior to the time at which investor commitments become binding; (ii) form part of the constitutional documents of the investment fund; and (iii) provide investors with enforceable rights in the event of a breach of the policy.

Spreading Risk

Managing risk is at the core of the asset management industry, but there are numerous circumstances which may cause a fund to fail the requirement to operate with a view to spreading risk collectively throughout its entire lifecycle. For example, it may be difficult to spread risk during the early stages of a fundraise or as a fund begins to deploy capital. However, these objectives need not be met at all times, provided the manager “operates with a view” to achieving them, so managers should be clear on this point in the fund’s objectives and guidelines in its constitutional documents.

Operating income

An investment fund must be primarily designed to generate investment income or gains (or protect against risk), as opposed to operating income. Managers should therefore give careful consideration to the treatment of transaction fees for the benefit of the fund (although such fees are unlikely to be significant and will be ancillary to the primary activities of the fund).

Managed by an investment management professional

Whilst this condition would appear to overlap with the condition requiring an investment fund to be subject to a regulatory regime in the jurisdiction in which it is established or managed, its mere inclusion as a separate condition may suggest additional hurdles need to be considered. The Commentary suggests a fund should be treated as managed by an investment management professional where, amongst other factors: (i) the fund managers are not directly employed by the investors; (ii) the fund managers have national qualifications; and (iii) management compensation is linked to the performance of the fund.

Exclusions for asset holding companies (AHCs)

It is common practice for investment funds to hold investments through AHCs, both in the case of standalone holding company structures for specific deals and where utilising a master holding company structure. This has commercial and regulatory benefits for the investment fund, including limiting liability, providing tax opacity and facilitating debt finance. Accordingly, without express exclusions, AHCs (in particular master holding companies which may produce consolidated accounts covering a number of portfolio investments) may need to comply with the top-up tax rules.

The OECD recognised the inclusion of AHCs in the investment management industry and therefore provided a specific exclusion in the Model Rules (which is mirrored in the UK draft legislation) for such entities. Broadly, an AHC may qualify as an excluded entity for the purposes of these rules if it meets the following conditions:

1. the AHC is 95% owned by "qualifying excluded entities" (the **ownership test**); and

2. almost of all of the AHC's activities consist of holding assets or investing funds for the benefit of those owners (the **activities test**).

Whilst satisfying the ownership test and activities test will require careful assessment by asset managers, it is noted that an investment fund (meeting the conditions described above) should be a "qualifying excluded entity" for these purposes, provided it is not a pension service entity. The benefits of the UK's qualifying asset holding company regime, for example, should therefore still be available for investment fund structures.

However, there will be more uncertainty for AHCs that form co-investment vehicles where there is a mix of qualifying excluded entities (such as investment funds meeting the criteria above) and non-qualifying entities investing in such vehicles. AHCs may also fail to meet this test where a single-investor vehicle is utilised in a parallel fund structure. Until further guidance on this issue is published by HMRC or the OECD, this should be given careful consideration when structuring AHCs.

Considerations for portfolio investments

Although the Model Rules are unlikely to come into effect in domestic legislation (in the UK or elsewhere) before the end of next year, funds should now start assessing the potential economic and compliance impact of these rules on portfolio investments.

By way of example, financial modelling for prospective buy-outs or bolt-on acquisitions will need to take into account the potential impact of top-up tax charges on the tax profile of multinational groups. Further, whilst traditional valuation exercises may be based on the underlying earnings of a business before tax (determined using enterprise value based on a multiple of EBITDA), these rules are likely to have an impact on cash-flow modelling when considering the potential returns for target groups.

However, given that the general size of portfolio companies under the control of private equity funds is significantly below the €750 million revenue threshold, these rules may present a competitive advantage for private equity bidders. Simply, a corporate buyer that is above the revenue threshold would need to assess the impact of the top-up tax on a bolt-on acquisition, whereas a private equity bidder may not for the same acquisition.

Additionally, the top-up tax rules present a number of deal and corporate structuring considerations that will need to be carefully navigated. These include the choice of jurisdiction for group companies, as jurisdictions which provide tax reliefs and benefits that align with the outcomes of the Model Rules will be significantly more favourable than jurisdictions where the tax reliefs offered are excluded from the calculation of the group's effective tax rate.

Conclusion

Although most funds (and their AHCs) are expected to be excluded from the application of these rules, managers should ensure they meet the applicable conditions for their vehicles to be excluded entities. Failing to meet these conditions will increase the administrative burden of managing the tax affairs of such investment vehicles.

Regardless of the application of the top-up tax to fund vehicles, the rules may impact large portfolio companies. Portfolio management teams should therefore proactively deal with compliance and take into consideration the impact of these rules on financial modelling.

It remains to be seen how HMRC will approach the application of the top-up tax and how much emphasis it will place on the Commentary when interpreting the finer details of these rules. Additionally, there are circumstances where the Commentary remains silent and, until further guidance is provided, certain judgments will need to be made as to the application of the top-up tax in the asset management industry.

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