The AIFMD
A regulatory directive with tax implications

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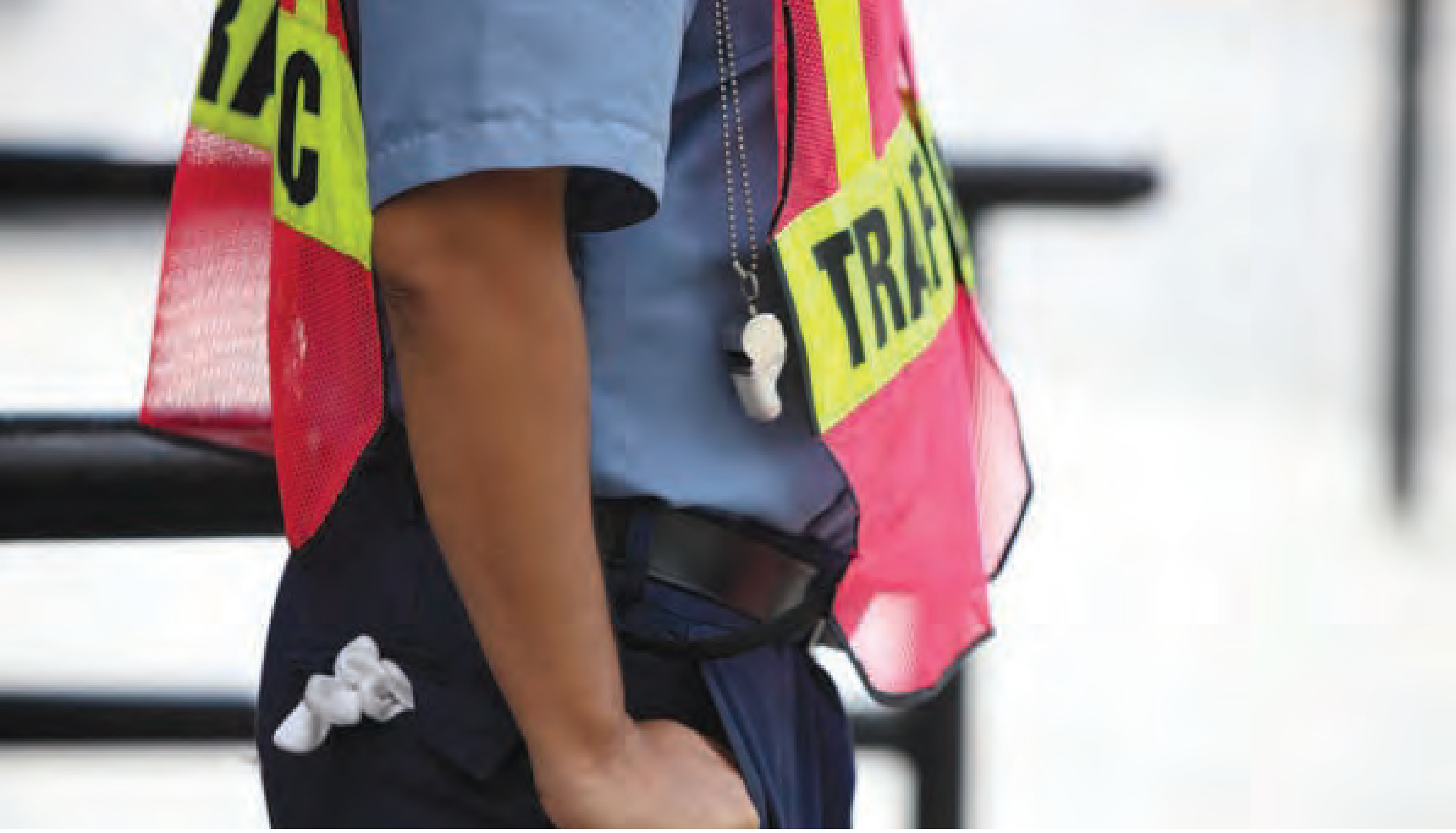
"If it moves, tax it. If it keeps moving, regulate it (...)" is a well-known quote by Ronald Reagan. This quote aptly describes the impact of the 2008 financial crisis on the financial sector (including the alternative investment fund industry), an industry which has become the subject of greater scepticism and scrutiny from public authorities, regulators and the political community[1].

The Alternative Investment Fund Managers Directive (AIFMD), which was adopted by the European Council on the 27 May 2011, is not a 'tax' directive per se, unlike the EU Parent-Subsidiary Directive[2], for example. However, in practice, the AIFMD will impact the business model of Alternative Investment Fund Managers ('AIFMs') by introducing a number of requirements or opportunities having a strong impact on their tax positions both on a domestic and cross-border basis. The European Commission also published on 19 December 2012 the level 2 regulation that will provide the basis for implementing the AIFMD across the EU.*

The AIFMD has not yet been implemented in the various domestic laws of the EU member states[3], even though discussions have begun in several countries.

** Please note that the European Parliament and Council of Ministers now have a 3 month period in which to object to the Commission's Regulation. As the level 2 regulation was issued simultaneously to the drafting of the present article, further details re. the level 2 measures were not included*



1. Substance considerations for AIFMs and capital requirements

Generally speaking, a company should be considered as 'tax resident' in a country where it has its statutory seat or its place of effective management. It means that a company might be tax resident only by virtue of its place of incorporation in some countries or circumstances.

Even though the concept of tax residency is not unique and differs from one country to the next, the AIFMD will set out a minimum level of substance for all management companies qualifying as AIFMs irrespective of the above.

The following specific substance conditions will indeed be required: a minimum level of capital[3], core functions[4] to be mandatorily performed by the AIFM and the need to have sufficient skilled human resources and technical competencies to carry out management activities.

These substance requirements combined with cross-border management opportunities (see next page) should encourage fund managers to re-think their business model and rationalise their cost structure (i.e. reduce the number of management companies similar to the UCITS environment) instead of duplicating compliance costs in multiple jurisdictions[5]. This potential trend could lead to the setting-up of management companies performing many functions loaded with a high level of substance and carrying a wide range of responsibilities potentially on a cross-border basis.

The tax environment offered by EU member states should play a major role in that respect.

1 Cf. e.g. proposal for a Directive on a common system of Financial Transaction Tax (known as 'FTT') which is notably aimed at sharing the cost of the economic crisis with the financial sector

2 Directive 90/435/EEC dated 23 July 1990, as amended from time to time

3 Minimum capital of €125,000 plus, when the portfolio value exceeds €250 million, additional funds of 0.02% of the amount over €250 million with a €10 million cap

4 The investment and risk management functions will have to be provided by the AIFM in order to qualify as such

5 The cost related to the use of multiple management companies could however be balanced by other considerations

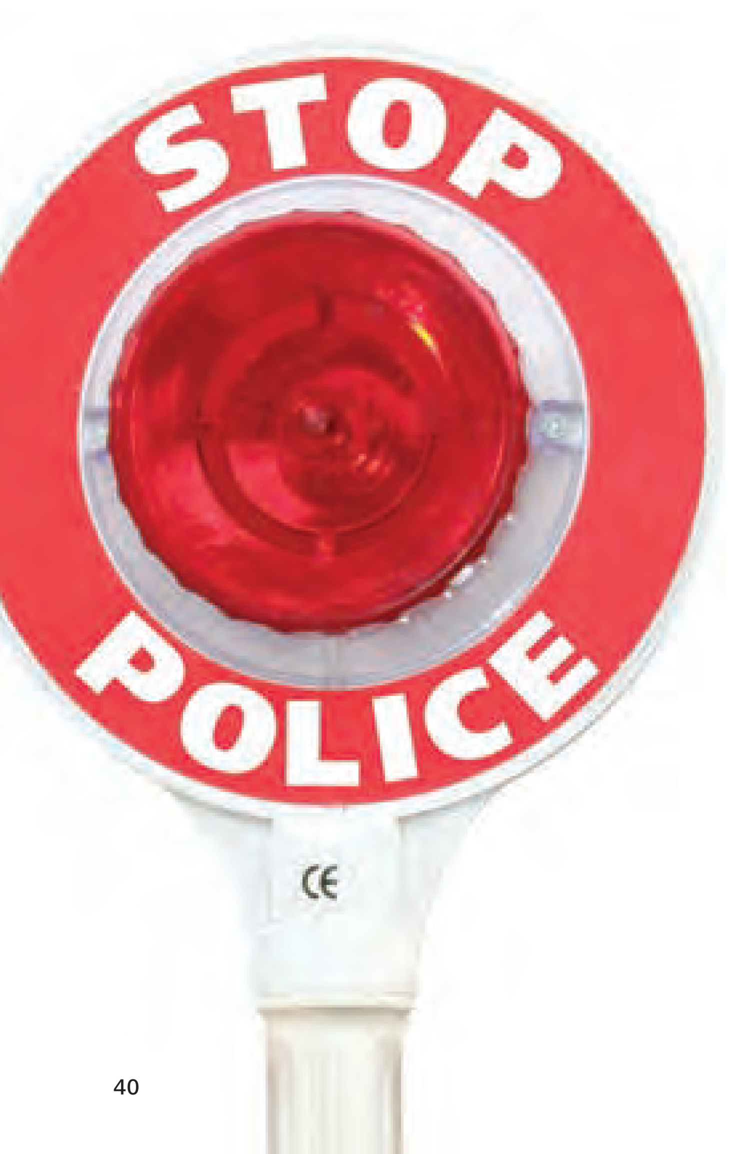
2. Cross-border management of AIFs and delegation

Multiple questions are raised at the level of AIFMs with regard to the possibility to delegate some functions externally and to manage AIFs located in a foreign jurisdictions.

Cross-border management

Similar to what UCITS did for products and their management companies, an authorised AIFM established in a member state should be allowed to manage AIFs established in other EU member states or in third countries (directly or through a branch).

However, the AIFMD does not address tax impacts of cross-border management.



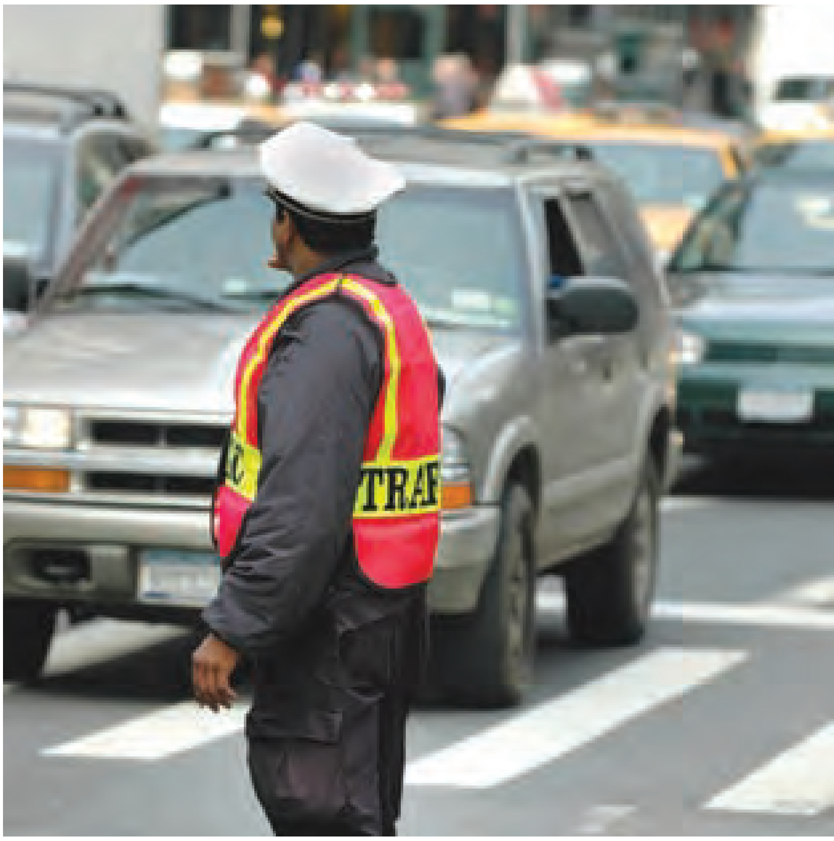
The management passport opportunities afforded by the AIFMD are likely to trigger taxation issues very similar to those experienced in the UCITS environment which could become (in practice) an obstacle to the effectiveness of the passport. For example, Luxembourg has attempted to address such issues in its draft law transposing the AIFMD (the 'Draft Law'[6]) by providing that AIFs established outside Luxembourg and which have their effective centre of management or central administration in Luxembourg should notbe considered as subject to Corporate Income Tax,Municipal Business Tax and Net Wealth Tax in Luxembourg[7].

A limited number of other member states implemented similar provisions for UCITS and it is not yet known whether AIFMD will be implemented in the other countries with such a similar tax-efficient provision. Whether Luxembourg AIFs managed by foreign AIFMs will benefit from the same favourable tax provisions in other countries is therefore still an open question.

From a Luxembourg perspective, such AIFs would continue to benefit from the Luxembourg tax regime[8] but the country where the AIFM is located might also claim the tax residency of the Luxembourg AIF[9]. Considering that each EU member state has its own tax system without harmonisation[10], such Luxembourg AIF would then be fully subject to the foreign corporate income tax regime, possibly without any exemption. This situation could also lead to adverse tax implications at investor[11] and investment level.

The Alternative Investment Fund Managers Directive is not a 'tax' directive per se

Simultaneously, it could also be anticipated that cross-border management would, under certain circumstances, trigger the recognition of a taxable presence (known as 'permanent establishment'[12]) where such an AIF is located and with respect to the revenue generated by the activities performed by the AIFM in that country.



Permanent representative

A non-EU AIFM wishing to perform marketing activities in the EU will be required to obtain authorisation in a member state of reference in the EU. It is this member state that will issue the AIFM's passport. The choice of member state of reference is not a free choice however. There are a number of selection criteria set out in the Directive based primarily on the locations of the AIFs and assets managed and/or where they are marketed. The AIFM must then appoint a legal representative in the member state of reference who acts as the contact person for investors, ESMA and the member states' competent authorities.

The legal representative must be sufficiently equipped to perform at least the compliance of the AIFM in the EU, which raises the question as to whether this will create a local taxable presence. At this stage, it is difficult to anticipate how such a concern will be dealt by the EU member states.

External delegation

The AIFMD also authorises the external delegation of some of its responsibilities to the AIFM (including core functions such as the investment management, as long as the AIFM does not become a letter box entity) thus raising not only tax residency or permanent establishment issues (see above) but also transfer pricing concerns.

6 A draft transposition law was submitted to the Luxembourg Parliament in August 2012

7 A similar provision (article 179) is foreseen by the Law dated 17 December 2010 implementing the UCITS IV Directive

8 As an example, a SICAV would be still tax-exempt (but subject to subscription tax) and an FCP would also still be considered as tax transparent from a Luxembourg tax perspective. A SOPARFI qualifying as an AIF would still benefit, for example, from the parent-subsidiary Directive as implemented under Luxembourg law

9 The place of effective management is usually prevailing over the registration seat within an international context

10 The potential tax-exempt regime offered locally is generally offered only to domestic funds complying with purely national requirements

11 E.g. investors in a mutual fund could lose the benefit of the tax transparency of the fund or could be subject to taxation on unrealised gains

12 Generally, a permanent establishment is materialised where a company located in country A is carrying out non-ancillary activities through a fixed place of business in country B. This concept is defined by the OECD model convention and gives rise to much case law throughout the world

Transfer pricing

Since the financial crisis, EU tax authorities have, generally speaking, become more sensitive with respect to the pricing of services between related entities established in different member states. This has led to them challenging transactions from a transfer pricing perspective, arguing that the pricing results in an artificial transfer of profit to a low-tax jurisdiction.

Similar challenges could arise for alternative investment funds especially if the AIF itself, the AIFM and the delegated entity are located in three different countries all claiming the right to tax a certain share of the management fees. In some circumstances, the fee structure would potentially have to be justified by transfer pricing studies.

VAT

From a VAT perspective one of the key questions is whether an AIF will be eligible to the fund management VAT exemption in the different EU member states.

The VAT aspects will generally need to be carefully monitored in a context where the cross-border flows of services will significantly increase.

3. Carried-interest

The AIFMD also affects the remuneration policy of AIFMs, which policy should now be consistent with effective risk management and do not encourage inappropriate risk-taking.

To achieve this result, the AIFMD and the Draft Law state, inter alia, that at least 40% of the variable remuneration should be deferred over the life-cycle and redemption period of the AIF and (ii) at least 50%[13] of the variable remuneration shall consist of shares/units in the AIF or other types of instruments linked to shares/ units in the AIF.

The definition of variable remuneration is still subject to many discussions at domestic and EU levels[14]. In the absence of a definite position, the related tax implications in all EU member states remain difficult to assess.

A non-EU AIFM wishing to perform marketing activities in the EU will be required to obtain authorisation in a member state of reference in the EU

13 There are exceptions where this threshold is not applicable

14 In particular, on 25 September 2012, the European Securities and Markets Authority (ESMA) held an open hearing on the consultation paper on the proposed remuneration guidelines for AIFMs released on 28 June 2012

4. Migration of offshore funds or management activities to the EU

Although no significant trend has yet been identified, the level of compliance stipulated by the AIFMD for non-EU AIFs distributed within the EU could lead to the migration of some offshore AIFs to onshore jurisdictions.

In general, there are multiple migration techniques, such as: the transfer of domicile of an offshore fund with the continuity of legal personality; the contribution of the assets and liabilities of an offshore fund to a new onshore fund followed by the liquidation of the former and the merger of an offshore fund with an onshore fund.

These migration possibilities involve different levels of complexity and/or tax implications depending on the EU Member States at stake and are sometimes only feasible for corporate funds.

5. Conclusion

We expect that asset managers will closely monitor how AIFMD will be implemented in the coming months under domestic laws.

The tax regime applicable locally and on a cross-border basis both to the AIFs and the AIFMs should impact the business models of a number of fund managers and create relocation opportunities.

It is not certain that all member states will propose a tax-efficient response to the alternative fund industry, which is viewed with suspicion.

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To the **Point**:

- The AIFMD is not a tax directive
- It will, however, be introducing a number of requirements or opportunities for AIF and AIFM that should greatly impact their tax positions both on a domestic and cross-border basis
- It is not certain that all member states will propose a tax-efficient environment to the alternative fund industry impacted by the AIFMD, thus creating relocation opportunities