# M&A Matters

October 2017

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# Contents

# Welcome to the October 2017 edition of M&A Matters

**M&A Matters incorporates the latest topical tax updates with a broader review of M&A insights.**

We begin the October issue in full swing with Rob Norris and Mark Eaton providing an update on the corporate interest restriction regime and the implications for M&A transactions.

Then, Tim Jones, Sarah Reynolds and Ian Mullen from KPMG Indirect Tax Advisory give an update on HMRC guidance for VAT recovery for holding companies, a topic we know is keenly watched on the deal side.

Robin Walduck, James Sia, Mark Hutton and Sarah Beeraje guide us through the latest on the OECD BEPS (base erosion and profit sharing) project, in particular multilateral instruments, and other topics requiring careful attention. Richard Phillips and Lucy Elkins present to us two cases highlighting the growing importance of contractual interpretation and the approach of the courts.

We have a broader update on the Alternative Investment Fund Managers Directive (AIFMD) by Julie Patterson and Zeeshan Arshed and the outlook for the future.

To round us off, Giuliano Bidoli and Sophie Richard from KPMG in Luxembourg take us on a tour of the European anti-tax avoidance directive (ATAD 2) and its measures in dealing with hybrid mismatches.

We hope you will enjoy our latest edition of M&A Matters. If you would like further detail on the articles in this, or any previous issues, please call us, the authors, or your usual KPMG contact.

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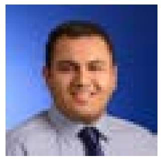

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# CIR and the implications for M&A transactions

**Following the publication of the summer Finance Bill, we now have confirmation the corporate interest restriction ("CIR") regime is due to apply from 1 April 2017 whatever a company's year-end. In this article, we consider the implications for M&A transactions.**

### Key points

- When modelling post-acquisition cash flows, the impact of the CIR rules on the expected tax relief for financing costs is vital – we recommend that modelling is undertaken early on before the structure is determined – the previously held assumption that bank debt will be fully deductible may no longer be valid.
- The CIR rules operate by reference to a worldwide group which is headed by its ultimate parent – changes to the ultimate parent impact the CIR calculations.
- If electing to use the group ratio method the deductibility of interest-like expenses will depend in part on group interest from the group accounts and certain interest (i.e. payable to related parties) is excluded which reduces the capacity to deduct interest.

## Introduction to the CIR regime

Under the corporate interest restriction (CIR) rules, interest-like expenses are disallowed to the extent that the net finance charge taken from the UK tax computations exceeds the interest capacity.

The interest capacity is based on a percentage of tax-EBITDA (taken from the tax computations) or, if lower, a measure of the net interest expense, based on the group accounts (the debt cap), but is always at least £2 million.

## Modelling impact of the CIR rules – new approach required

The approach to modelling post-acquisition cash flows must now take account of the impact of the CIR rules on the expected tax relief for financing costs as, going forwards, modelling will become much more difficult.

The model must take into account the hybrid and other mismatch rules and the interaction with the revised loss utilisation rules. The combination of rules and restrictions is leading to greater complications and we're seeing old assumptions being thrown out the window.

## Identifying the CIR group

The CIR rules operate by reference to the 'worldwide group'. In particular, the total disallowed amount is computed on a groupwide basis and is then allocated between UK group companies. It is vital to correctly identify the ultimate parent and which entities comprise the worldwide group. Typically this follows the International Accounting Standards (IAS) definition of consolidated subsidiaries.

Generally speaking, a worldwide group will consist of all entities that would form part of a group applying IAS; broadly, a parent and its consolidated subsidiaries. An IAS parent will only be treated as the ultimate parent if it is a 'relevant entity', which is defined as a company or an entity whose shares, or other interests, are listed on a recognised stock exchange and are sufficiently widely held (i.e. no participator holds more than 10 percent by value). The CIR grouping rules mean that a partnership is only capable of being the ultimate parent of a worldwide group if it meets the relevant conditions described above.

A subsidiary under IAS will not qualify as a CIR subsidiary if the investment in that company is measured at fair value under IAS (as opposed to having its results consolidated on the more normal line-by-line basis). Such a company is excluded from the CIR group of its IAS parent.

For groups which are owned by private equity partnerships, particular care will be required to identify the ultimate parent.

## Impact of the CIR rules – utilisation of carried forward amounts

The CIR rules provide for disallowed interest-like expenses and unused allowances to be carried forward to a later period. If there is a change in ownership of a company or group, an assessment is required as to whether these attributes are still available and who can access them.

- Carried forward interest allowance: Net interest-like expenses for UK companies are deductible to the extent they do not exceed the interest allowance for the current period plus the interest allowances carried forward from earlier periods that have not expired. The unused interest allowance for a period can be carried forward for up to five years and may allow more of the interest-like expenses, which arise in a later period, to be deducted. This is an attribute of the group and not of any particular company in that group.
  - Where a group is acquired, the 'old' group ceases and any carried forward interest allowance is lost. Similarly, any carried forward allowance will be lost where a new top holding company is inserted which becomes the 'new' ultimate parent of the group, e.g. if a new holding company is added in preparation for an IPO.
  - Where a subsidiary is sold or purchased, they will not be able to take with them any interest allowance from when they were a member of the seller group; instead the seller group will retain the ability to utilise any carried forward interest allowance.

Carry forward and reactivation of disallowed interest: Interest-like expenses which have been disallowed are carried forward as an attribute of a company and may be deducted by that company in a later period where there is "headroom" in the amount of the allowable interest. This attribute is carried forward across the sale of the company or a change in the ultimate parent, broadly, provided that the activities of the company continue. The existing change in ownership rules (in *Part 14 CTA 2010*) and the proposed new loss utilisation rules have not been extended to amounts carried forward under the CIR rules. However, the CIR regime targeted anti-avoidance rule and possibly the transfer of deductions anti-avoidance provisions (in *Part 14A CTA 2010*) could be relevant.

- Carry forward of excess debt cap amount: The deductibility of net interest for a period is based, in part, on the debt cap allowance (using figures from the group accounts). Where there is a disallowance in a period and the debt cap is not the limiting factor, the excess debt cap amount can be carried forward and may result in more interest being deducted in a future period. This is carried forward as a group attribute in a similar manner to a carried forward interest allowance.

It should be noted that whereas a group's capacity to access relief for current year interest is increased by any unexpired interest allowance carried forward from earlier periods (see above), its capacity to reactivate interest disallowed in prior years only takes account of the current period interest allowance. It is generally unlikely that a group would have both carried forward disallowed interest and a carried forward unused interest allowance but this could arise following an acquisition. For example, where a group with unexpired carried forward interest allowances (and no previous disallowances) acquires a company with carried forward disallowed interest, it will only be possible to reactivate such disallowed interest to the extent that the group has current year excess interest allowance after the acquired company has joined the group. This illustrates the level of detailed understanding of the rules which will be required to model the impact of the acquisition.

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### Tax Matters Digest "devil is the detail" series of articles

- Further details of the CIR rules are provided in a series of weekly Tax Matters Digest "devil is in the detail" articles which look at aspects of the CIR rules in "bite sized chunks"

## Related parties

For each period, a group can elect to calculate the interest allowance based on the group ratio method. Under this method, the interest capacity is based, in part, on a group accounts measure of net interest-like expenses (known as qualifying net group-interest expense). For these purposes, interest-like expenses payable to a related party are not included, thereby reducing the capacity to deduct interest. If the group ratio method is to be used, it will be necessary to assess whether the group is paying interest etc. to related parties.

For example, bank borrowing can be treated as being from a related party where a guarantee, indemnity or other financial assistance is provided by a related party who is not a member of the group. However, a bank's security package should not cause them to be treated as a related party in relation to the borrowing, provided the guarantee is only from companies within the group.

Where a group is owned by private equity partnerships, particular care will be required to identify funding from related parties.

## Changes in composition of the group – interaction with the CIR elections

The CIR rules contain over fifteen possible elections which can mostly be made or amended after the end of a period. Where companies are purchased and sold, it will be necessary to assess the impact of elections on the acquired company or group.

- Some elections are made for the group. Where a company becomes a member of a new CIR group, any such election will cease to apply to the company and calculations will be based on whether the "new" group has made an election.
- Alternatively, an election may be made by a company which is unaffected by leaving or joining a group.

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# CIR and the regime anti-avoidance rules

**The CIR regime contains what HMRC draft guidance describes as a regime anti-avoidance rule (RAAR) counteracting certain arrangements achieving a better result under the CIR rules than would otherwise be the case. Groups will need to consider whether the RAAR applies to any restructuring transactions that may affect the group's overall disallowance (or reactivation) of interest under the CIR rules. The RAAR is broadly drafted and, unlike similar anti-avoidance provisions, does not contain a general exclusion for arrangements that are consistent with the principles and policy objectives underlying the CIR rules.**

## Overview of the RAAR

The RAAR provides that any 'tax advantage' that would arise from 'relevant avoidance arrangements' is to be counteracted by the making of such adjustments as are just and reasonable.

Arrangements are 'relevant avoidance arrangements' if both:

- The main purpose, or one of the main purposes, of the arrangements is to enable a company to obtain a tax advantage; and
- The tax advantage is attributable (or partly attributable) to any company:
  - Not having amounts disallowed under the CIR rules that would otherwise have been disallowed (or having lower amounts disallowed or having amounts disallowed in a different accounting period); or
  - Reactivating previously disallowed amounts under the CIR rules that would not otherwise have been reactivated (or having greater amounts reactivated or having amounts reactivated in a different accounting period).

When assessing whether there is a tax advantage, 'tax' includes any amount chargeable as if it were corporation tax or treated as if it were corporation tax (e.g. controlled foreign companies (CFC) charge and bank levy) and diverted profits tax.

It should be noted that the anti-avoidance rule does not test whether there is a tax advantage solely under the CIR rules but whether there is an overall tax advantage under the taxes within its scope.

## Transitional rules

The general rule is that the RAAR applies in relation to arrangements whenever entered into (i.e. including any arrangements entered into before 1 April 2017).

However, three transitional exclusions are available.

### Exclusion 1 – arrangements that accelerate deductions pre-1 April 2017

The RAAR will not apply to arrangements so far as they reduce the amount that would otherwise be disallowed under the CIR rules post-1 April 2017 via paying amounts before 1 April 2017.

HMRC draft guidance says this might involve paying interest which is deductible on a paid basis before the commencement of the CIR rules where this would otherwise be disallowed if paid post-commencement, or paying non-interest expenses, such as pension contributions, before commencement that would otherwise reduce tax-EBITDA and therefore the group's capacity to deduct interest post-commencement of the CIR rules.

### Exclusion 2 – loans being brought into the UK

The RAAR will not apply if the tax advantage can reasonably be regarded as arising wholly from arrangements entered into in connection with the commencement of the CIR rules that (but for the CIR rules) would have resulted in significantly more corporation tax becoming payable as a result of one or more loan relationships being brought within the charge to corporation tax.

HMRC draft guidance says this might involve a group transferring interest bearing loans from a CFC to a UK group company.

### Exclusion 3 – arrangements securing CIR reliefs

The RAAR will not apply if the tax advantage that would otherwise be obtained can reasonably be regarded as arising wholly from arrangements entered into in connection with the commencement of the CIR rules that

– are designed to secure the benefit of a relief expressly conferred by the CIR rules in a way that is wholly consistent with its policy objectives and

– are effected by taking only ordinary commercial steps in accordance with a generally prevailing commercial practice.

HMRC draft guidance says this might involve a group restructuring so as to

– allow the group to be able to benefit from the public infrastructure rules or

– refinance debt that would not qualify as "qualifying net group-interest expense" with debt that does qualify (thereby potentially increasing the amount of interest allowable under the group ratio method), e.g. refinancing perpetual debt with debt that has a fixed term of less than 50 years.

Note that even if the RAAR does not appear to apply, other existing anti-avoidance rules may also need to be considered.

## Conclusion

Given the broad nature of the RAAR, parties engaging in M&A financing transactions should give consideration to these rules.

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# Input VAT recovery by holding companies on transaction costs

## After almost 20 years of discussion – where are we now?

Input VAT recovery in respect of deal-related costs has been an area of intense interest to HMRC for many years, following a number of landmark legal cases. HMRC finally published its latest guidance earlier this year in VAT Manual VIT40600, which sets out what it now considers to be the criteria for input tax deduction by HoldCos (holding companies).

This article explains what the new HMRC guidance says, explores some remaining uncertainties and suggests what best practice now looks like.

## Summary of input VAT recovery guidance

In order for a HoldCo to be in a position to deduct VAT incurred on deal fee costs, HMRC states that it needs to satisfy the following two main conditions:

- It must be the recipient of the supply, i.e. it has contracted for the supply (including by novation), it has made use of the supply, and has been invoiced and paid for the supply; and
- The costs on which VAT is incurred must have a direct and immediate link to taxable supplies conducted by the HoldCo (or the VAT group that the HoldCo is a member of).

Importantly, the HoldCo must be undertaking an economic activity in order to have any possibility of recovering the VAT it incurs, even if it is a member of a fully taxable VAT group. In order to demonstrate the necessary direct and immediate link for VAT recovery, the costs incurred may relate to:

- Taxable supplies made by the HoldCo in its own right, e.g. management charges; and/or
- If HoldCo is VAT-grouped, its economic activities should support taxable supplies made by the VAT group, e.g. management services or interest-bearing loans to other VAT group members that make taxable supplies outside the VAT group.

So far, so good – we now have a clear set of principles issued by HMRC that, to be deductible, input VAT must be incurred by a taxable person in the course of an economic activity and have a direct and immediate link to taxable supplies made by that person. Where these conditions are not met (e.g. because the HoldCo is not the recipient or it has no economic activity), the HoldCo cannot recover any VAT on the deal costs.

## Undertaking an economic activity for VAT purposes

The difficulty that many HoldCos have is being able to show that the VAT incurred relates to an economic activity – as often a HoldCos' activities tend to be more "passive" in nature (e.g. holding of shares, receiving dividends, etc.). It was accepted back in 1993 *(Polysar)* that the mere acquisition and holding of shares is not an economic activity for VAT purposes.

HMRC accepts this "economic activity" condition will be met where evidence exists to show that a HoldCo makes, or intends to make, supplies of management services for a consideration to its subsidiaries.

However, following the ECJ decision in *Larentia + Minerva (C-108/14)*, HMRC consider that the holding of shares (a non-economic activity) can only be disregarded in relation to those subsidiaries to which taxable management services are supplied.

Therefore, where a HoldCo only makes supplies to some of its subsidiaries, the holding company will be undertaking a mixture of economic and non-economic activities, and an apportionment of VAT recovery will be appropriate between these two activities. On this basis, full VAT recovery would only be an option for HoldCos that make supplies to all of their subsidiaries. HMRC's guidance does not consider the VAT implications where the subsidiary receiving the supply does not undertake any economic activity.

HMRC's guidance states that for VAT to be recoverable, a direct and immediate link is required between the deal costs and the management services carried out.

## When is a separate Master Service Agreement (MSA) not required?

This was an unexpected surprise. HMRC states that where a shareholding is acquired as a direct, continuous and necessary extension of a taxable activity of the HoldCo, a separate activity (e.g. management services) is not required to facilitate VAT recovery on associated costs. This is thought to have come as a result of the UKFTT case of Heating Plumbing Services Ltd – in which the Tribunal found that where the purpose of an activity is to further strengthen the business, the VAT on associated costs is recoverable – without the need for a specific MSA to be put in place – as they relate to the existing economic activity of the business.

However, it appears that HMRC may only seek to allow this approach in limited circumstances and as advisors we think it more likely that this test would apply to a steady-state corporate acquisition rather than a finance-backed acquisition where the SPV set up to acquire the target joins the target's VAT group upon acquisition.

HMRC provide an example in their guidance of where a business acquires a direct competitor or a similar/complimentary business with a view of increasing its own market share and achieving efficiencies through greater integration of its supply chain as being a direct, continuous and necessary extension of a taxable activity of the holding company.

By contrast, a company which purchases a business as a free standing enterprise with a view to making money on dividends or an eventual sale does not have a direct, continuous and necessary link as there is there is no direct link between the acquisition and the existing business.

## Costs incurred by the "Target"

This is also good news - HMRC's confirmation that the VAT incurred on the costs by the target of an acquisition – vendor due diligence costs for example – may also be recoverable where it can be shown the target is the true recipient of the supplies in question, and the supplies were received for the purposes of the business carried on by the target.

HMRC had previously argued the target could never have received the services since it was not the entity making the supply. Happily, HMRC have changed their view in this regard.

## VAT-grouping

Again, this is where the guidance (and its former versions) arguably departs from conventional legislative interpretation of a VAT group as a single taxable person.

HMRC says that joining/forming a VAT group does not automatically give rise to an entitlement to a HoldCo to recover VAT. It does, however, if the VAT relates to "stewardship costs" – costs described by HMRC as being received by the HoldCo for the purpose of the VAT group as a whole (e.g. audit fees, regulatory compliance fees, brand defence, bid defence, group legal costs, etc.). But it does not if the costs relate to an M&A-type transaction. In these circumstances, HMRC state that joining a VAT group does not, in of itself, change a non-economic (passive shareholding activities) into an economic activity; nor does it create the necessary direct and immediate link to the taxable outputs of the group as a whole.

## VAT on aborted costs

Deals do abort. The ability to recover VAT is not restricted simply because a deal aborts, as decided back in 1998 in the CJEU decision in *Ghent Coal*. In these circumstances, VAT can still be recovered subject to the normal rules and conditions for input tax recovery, that is to say:

– The entity commissioned the services (or they were novated to them); and

– The costs were for an economic activity, or – more appropriately in this case – an "intended" economic activity.

Where a deal aborts, it is the *intention* to have an economic activity (and ability to demonstrate this) which supports VAT recovery.

## The KPMG best practice principles

There are a number of practical steps business can take to put HoldCos in the strongest possible position to facilitate recovery of input VAT on deal costs. These would include, but are not limited to:

– Seek advice as early as possible;

– Be registered for VAT as soon as possible if not already (at the latest time of incurring costs);

– Ensure that supplier agreements are in place and reflect the correct company as contracting party (including by novation), that it is the recipient of the services and is identified as the person that will be invoiced and pay for the services;

– HoldCo must have substance and undertake a genuine, demonstrable taxable economic activity (e.g. management services) to all of its subsidiaries, the value of which must be more than nominal. The intention to make these supplies should be documented as soon as possible in a formal agreement.

– HoldCo should then actually make, invoice and be paid for the services in accordance with the contract.

– Agree what economic activity HoldCo will undertake – consider other non VAT implications of these;

– Document the rationale for VAT recovery on each invoice – for good order and protects against potential penalties should HMRC ever successfully challenge recovery – noting HMRC are likely to review first repayment VAT returns.

## Impact of Brexit

UK VAT principles stem from European VAT legislation and case law. As such, there is uncertainty as to what the UK's departure from the EU will mean for UK VAT rules, but a reasonable expectation as regards input VAT recovery on deal costs is that HMRC will not look to reverse its latest position. HMRC have spent many years litigating and refining their position and are unlikely to want to go through many more years of the same. This should mean that the best practice principles set out here are expected to remain relevant post-Brexit, though close monitoring of future developments will of course be essential.

## Conclusion

Notwithstanding some remaining uncertainties, it is clear from this guidance, that with some early planning, it should be possible for a HoldCo to minimise the level of otherwise irrecoverable VAT.

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# The Multilateral Instrument (MLI) and its impact on cross border tax treaties

**The signing in June of the OECD's Multilateral Instrument (MLI), by representatives from 68 countries and jurisdictions, is a major landmark for tax treaties worldwide. We explain what the MLI is – and its likely implications for multinational businesses.**

## What is the MLI?

The MLI is being introduced as part of the OECD's base erosion and profit shifting (BEPS) project, in order to implement a number of tax treaty measures recommended by the BEPS. These relate to treaty abuse, permanent establishments, dispute resolution and hybrid mismatches.

The MLI is the output of the final BEPS workstream (Action 15) and will update an existing network of around 1,100 bilateral tax treaties.

It will put in place:

- measures to prevent treaty abuse (BEPS Action 6);
- changes to the definition of permanent establishment (PE) (BEPS Action 7);
- neutralising the effects of hybrid mismatch arrangements (BEPS Action 2); and
- mutual agreement procedures and mandatory binding arbitration (BEPS Action 14).

As part of the signing procedure, the OECD provided countries with templates to allow them to file a list of their agreements that are covered by the MLI. A document containing this information, with links to the official statement for each jurisdiction (in terms of covered tax agreements, and provisional options and reservations) has now been *published* by the OECD on their website, along with a *matching database*.

The OECD does not plan to prepare consolidated texts of treaties (a document that combines the MLI components). They are expecting local governments to handle this on a domestic basis, if they choose to do so at all.

The changes in the MLI apply only if both parties to a double tax treaty have designated it as a 'Covered Tax Agreement' (CTA). Not all countries have designated all their treaties as CTAs, although it is likely that, once the MLI is ratified by each country, more agreements will be added.

> "The MLI is the output of the final BEPS workstream (Action 15) and will update an existing network of around 1,100 bilateral tax treaties

Parties to the MLI have the freedom to opt-out of certain parts of the instrument, and some such opt-outs have already been announced:

- Minimum standard anti-treaty abuse rule: the MLI allows opt-out only where the CTA already has an equivalent anti-abuse rule.
- The anti-abuse principal purpose test (PPT) will be adopted by all current signatories, with some countries also intending to supplement the PPT with a limitation on benefits clause (either through the MLI itself, or through subsequent bilateral negotiation with treaty partners).
- The mandatory binding arbitration provision will be signed by 25 jurisdictions, with further signatories expected, once appropriate carve-outs are agreed.
- The various changes to the PE definition will each be adopted by between 35 and 65 countries. The provisions on anti-fragmentation and the specific activity exceptions will be more widely adopted than the provisions for dependent agent.

## Key dates for the MLI

The MLI will enter into force once five countries have deposited instruments of ratification to effect implementation under their domestic legislation. The OECD currently believes that this threshold will be reached by 30 September 2017. At that point, the MLI will enter into force for treaties between those countries which both contracting states have designated as a CTA.

However, the date the MLI enters into force is not the same as that from which it takes effect. If the threshold of five countries depositing instruments of ratification is reached in September 2017, the MLI changes relating to those CTAs apply, for withholding tax purposes, from 1 January 2018 (unless the contracting state in question opts for them to apply from the start of the next following taxable period). For all other purposes, changes will apply for taxable periods beginning on or after 1 July 2018 (unless the contracting states agree on an earlier date).

## What will the MLI mean in practice?

Given the range of tax areas that the MLI covers – and the large number of signatories – the MLI represents a major change in the tax landscape for many companies. That's especially true for those with cross border activity. At the very least, the changes to treaties thanks to the introduction of the MLI will alter the approach that companies need to take in assessing the availability of treaty relief. That, in turn, is likely to increase process and administration, especially in the early years of implementation.

For those groups engaging in M&A activity, it will be critical that the impact of the MLI is included within the scope of due diligence reports, both in terms of potential tax liabilities and to obtain an understanding of the potential additional tax administrative burden.

In addition to the administration aspects, the MLI may also impact the structure of financing for transactions, for example, in relation to the availability of treaty relief for financing costs. Post-acquisition, companies may also wish to review their legal, financing and operational structures in light of the MLI, to proactively manage the impact.

> “Given the range of tax areas that the MLI covers – and the large number of signatories – the MLI represents a major change in the tax landscape for many companies

## How do you find out more?

For more information on the MLI, various KPMG resources are available to clients:

– KPMG International published a *Global Tax News Flash*, which provides a more detailed explanation of the MLI. It includes a number of links to both OECD documents and the Tax News Flash alerts from local KPMG offices.

– In addition, a client webinar was held on 13 June 2017. A copy of the slides and the playback recording are available *here*. The webcast set out details of the MLI in overview, including the mechanics of operation, and then went on to explore the impact on a region by region basis. In Europe this included a specific focus on the UK, Ireland, the Netherlands, Germany and Switzerland.

– The OECD has released a *tool* which matches the MLI positions put forward by the different signatories. Alongside this, KPMG International is in the process of developing additional content for KPMG member firms to use in their conversations with clients; this will help multinationals to check the potential impact of the MLI on their fact pattern.

The MLI is relevant to a number of areas of international tax. KPMG in the UK's specialist teams covering corporate structure effectiveness, value chain management and dispute resolution are collaborating closely to provide a co-ordinated approach to assisting clients.

### MLI and your business

There is no doubt that the MLI will significantly change the tax operating landscape for multinationals. Whilst it inevitably introduces a number of administrative changes, groups may also consider where it might open up opportunities for streamlining business structures and proactively managing cross border transactions.

If you have any questions about the MLI, including its potential impact on your business, please get in touch with your usual KPMG contact or Robin Walduck, Mark Hutton or James Sia.

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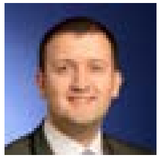

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# Contractual interpretation

**Two recent court cases show that, when it comes to business contracts, the common law is moving towards a more holistic approach, rather than a strict black and white interpretation of the wording alone.**

## Executive summary

Two recent Court of Appeal and Supreme Court cases have confirmed key components of the existing legal framework for the interpretation of business contracts. At the same time, they have affirmed the reluctance of the courts to step in where commercial parties are of equal bargaining power. These two cases show the common law continuing to move away from an approach based on strict interpretation, and towards one which seeks to balance the literal meaning of the wording, the contract as a whole, the wider context and business common sense in order to interpret wording.

In its judgement earlier this year in *Persimmon Homes Limited & Ors v Ove Arup & Partners Limited & Ors*[1] (**Persimmon Homes**) the Court of Appeal considered the reduced application of the *contra proferentem* rule to exclusion clauses suggesting it is now only relevant to indemnity clauses. The Court of Appeal additionally held that the guidelines relating to exclusion of negligence clauses did not assist where the meaning of the clause was clear. In *Wood v Sureterm Direct Limited* (**Wood v Sureterm**), again earlier this year, the Supreme Court reconfirmed that the literal meaning of the language used, the contract as a whole and the wider context in which the contract was arrived at, where appropriate, should all be taken into account when construing the terms of a contract. Business common sense should be applied, but will always remain subordinate to the literal meaning, if this is clear.

## Traditional rules and guidance for interpretation

Traditionally, the *contra proferentem* rule applied to resolve any ambiguity in the interpretation of a clause or contract against the party who proposed it. The reasoning behind this is that a party who imposes terms on another must make those terms clear, and should be the one that suffers the consequences, if it fails to do so. It has tended to be applied to clauses or contracts that have not been negotiated.

Separately, the case of *R v Canada SS Lines Ltd [1952] AC 192 (Canada Steamship)* (**Canada Steamship**) established a number of key guidelines for interpreting clauses that seek to exclude liability for negligence. Canada Steamship's main principle is that, where one party seeks to avoid liability for its own negligence, that position must be spelt out expressly (and not in general terms).

## Persimmon Homes

The recent case of Persimmon Homes related to the redevelopment of an industrial site in Barry, Wales. The respondents (**Arup**) were engaged by the previous owners of the site as civil engineers to give advice and supervise the development. Following an initial

[1] Persimmon Homes Limited, Taylor Wimpey UK Limited, BDW Trading Limited v Ove Arup & Partners Limited, Ove Arup & Partners International Limited [2017] EWCA Civ 373

regeneration phase, the previous owners opened a tendering process. The claimants formed a consortium (the **Consortium**) that engaged Arup for consultant engineering services as part of the process of putting together the Consortium's bid. The Consortium was successful in its bid and purchased the site in September 2007. The Consortium and Arup then entered into a second agreement in September 2009 (the **2009 Agreement**). The 2009 Agreement included the following language in the exclusion clause:

*"…Liability for any claim in relation to asbestos is excluded. Arup additionally entered into deeds of warranty with each of the Consortium members in 2010, which included the same language in the exclusion clause."*

Separate consultants engaged by the Consortium discovered a large amount of asbestos at the site in 2012, which was substantially higher than the amount identified by Arup. The Consortium brought a claim for breach of contract, negligence and breach of statutory duty, arguing that it had suffered loss as, had they been properly advised by Arup at an appropriately early stage, they would not have paid as much for the site and would have not incurred the additional costs relating to the asbestos. Arup sought to rely on the exclusion clauses to shield itself from any liability.

The Consortium was unsuccessful at first instance, as the court held that the clauses excluded liability for all the claims made by the Consortium. The Consortium appealed the decision.

In its appeal, the Consortium made two arguments as to why the exclusion would not cover the claims being brought against Arup:

1. the exclusion clause did not encompass any claim for not identifying asbestos, as the words "liability for" in the exclusion should be understood to mean liability for "***causing the uncontrolled spread of***" the asbestos; or
2. in the alternative and any event, the exclusion clause would need to have words implied into it in order to exclude negligence, such that "liability for any claim in relation to asbestos (***unless incurred in negligence***) is excluded".

The Consortium also argued that the judged at first instance should have applied the ***contra proferentem*** rule and the Canada Steamship principles.

However, the Court of Appeal rejected the Consortium's arguments and upheld the lower court's decision for the following reasons:

1. despite the Consortium's argument to the contrary, the language of the exclusion clause was clear and unambiguous and, therefore, must be given its natural meaning and taken at face value. Accordingly, there was no basis to argue that the words "***causing the uncontrolled spread of***" needed to be inserted into the clause, particularly as this interpretation would have been contrary to business common sense;
2. as the wording was clear, the ***contra proferentem*** rule did not assist the Consortium. The court additionally commented that, in relation to commercial contracts negotiated between parties of equal bargaining power, the ***contra proferentem*** rule has only a very limited role, as the literal meaning, wider context and commercial common sense should normally be sufficient to determine meaning; and
3. commercial contracting and risk allocation have evolved greatly since the 1950s (when Canada Steamship was decided) and therefore the guidance provided by that case is of very little assistance in the present dispute.

"Traditionally, the contra proferentem rule applied to resolve any ambiguity in the interpretation of a clause or contract against the party who proposed it

## Wood v Sureterm

The case of Wood v Sureterm centred on the sale of a specialist insurance brokerage company, Sureterm Direct Limited (**Sureterm**), by Andrew Wood (**Mr Wood**), the majority shareholder, and two minority shareholders. The purchase of Sureterm was completed in April 2010. Under the sale and purchase agreement, the sellers had undertaken to indemnify the purchaser against losses and claims:

*"...imposed on or required to be made by [Sureterm] following and arising out of claims or complaints registered with the FSA, the Financial Services Ombudsman or any other Authority..."*

Shortly after completion, it was discovered that Sureterm had been mis-selling motor insurance policies. The purchaser and Sureterm notified the Financial Services Authority (**FSA**) under their regulatory obligations and agreed a remediation scheme where Sureterm paid compensation to customers potentially affected by the mis-selling. The purchaser subsequently brought a claim against the sellers under the indemnity in the sale and purchase agreement for the estimated cost of the compensation plus interest and the costs of the remediation scheme.

At first instance, the court held in the purchaser's favour that Mr Wood must indemnify the purchaser, even though the purchaser and Sureterm had self-reported the mis-selling to the FSA and there had been no claim or complaint by a customer. Mr Wood appealed this decision.

The Court of Appeal held that the indemnity only covered loss and damage which arose out of claims or complaints to the FSA by customers. The notification to the FSA by the purchaser and Sureterm was, therefore, not included in this. The purchaser appealed to the Supreme Court.

In dismissing the appeal, the Supreme Court held that, applying a literal reading of the indemnity, there had been no complaints from customers, which meant that the indemnity was never triggered. Whilst that may have been a bad bargain for the purchaser to make, it was not the job of the court to improve that bargain.

## Conclusion and implications

In their judgements in Persimmon and Wood v Sureterm, the English courts have confirmed the modern approach to exclusion clauses, which accepts that commercial parties to a contract are free to assign risks as they see fit – and that exclusion clauses, therefore, should be given their ordinary and natural meaning. The *contra proferentem* rule now has a very limited role in relation to commercial contracts negotiated between parties of equal bargaining power. It should only be applied in cases where there is genuine ambiguity as to meaning. Similarly, the test for interpreting exclusion clauses in Canada Steamship now has little relevance in the context of commercial contracts.

The recent line of cases in this area has highlighted the importance of clear drafting in contracts, as the ordinary and natural meaning of language will, usually, be given effect. The courts appear to have maintained their consistency in applying this approach, which will give a level of comfort to commercial parties that the courts will not seek to overturn wording freely negotiated. Importantly, it also emphasises the value of obtaining legal advice in relation to the drafting of commercial contracts. Parties engaging in M&A transactions should give consideration to the approach of the courts in light of the above.

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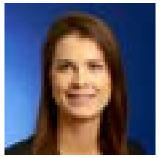

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# AIFMD update

In the four years since it was introduced, the Alternative Investment Fund Managers Directive has played a major role in regulating the sector. What are the latest developments – and what lies ahead post-Brexit?

## What is the AIFMD?

*The Alternative Investment Fund Managers Directive (AIFMD)* is a regulatory framework for alternative investment fund managers (AIFMs). Implemented on 22 July 2013, the AIFMD covers the management, administration and marketing of alternative investment funds (AIFs), with a focus on the regulation of the AIFM rather than AIF.

An AIF is defined as a 'collective investment undertaking' that is not subject to the Undertakings for the Collective Investment of Transferable Securities (UCITS) regime, including hedge funds, private equity funds, retail investment funds, investment companies and real estate funds, among others.

The AIFMD establishes an EU-wide harmonised framework for monitoring and supervising risks posed by AIFMs and the AIFs they manage, and for strengthening the internal market in alternative funds.

## Why was the AIFMD created?

The AIFMD was introduced in response to the credit crisis. The original intention was to regulate the hedge fund sector, but it now captures any type of collective investment vehicle that is not a UCITS. Its principle aim was to establish common requirements governing the authorisation and supervision of AIFMs, providing a coherent approach to the risks potentially spread or amplified through the financial system by the activities of AIFMs, and so reduce the impact on investors and markets.

The AIFMD brought with it enhanced transparency through rules on disclosure to investors and mandatory regular reporting to regulators (including conflicts of interest, remuneration, risk management, valuation, fund assets and exposures). It also strengthened cross-border competition thanks to the deregulation of inequitable nationwide barriers.

## What are the AIFMD's requirements?

The AIFMD requires AIFMs to be authorised and to comply with all its requirements ("full scope" AIFMs) or, where the AIFM's total AIF assets under management are below certain thresholds, to be registered and subject only to a reporting regime. If these 'sub-threshold' AIFMs wish to benefit from the AIFMD's marketing and management passports, they can opt-up to full AIFMD authorisation.

The AIFMD does not include any limits on hedging or leverage, but it allows European Securities and Markets Authority (ESMA) or national regulators to do so. Regulators already had in place or have introduced measures for AIFs sold to retail investors but, to date, most professional funds are not subject to such limitations.

## Asset stripping rules under the AIFMD

The greatest impact of the AIFMD in the private equity/venture capital sector has been through its asset stripping rules. These were designed to restrict the ability of Private Equity Funds to extract funds in the first two years of ownership, following an AIF taking control of an unlisted company (control for these purposes being holding at least 51% of a company) in certain circumstances. Specifically, the rules are:

– The portfolio company is not allowed to undertake any distribution (including dividends on shares), capital reduction, share redemption and/or acquisition of own shares;

– The AIF cannot vote in favour of a distribution, capital reduction, share redemption and/or acquisition of own shares by the company; and

– In any event, the AIF should use its best effort to prevent distributions, capital reductions, share redemptions and/or acquisition of own shares by the company.

The rules apply to restrict distributions of pre-acquisition profits – in other words, to avoid reducing a company's value by asset stripping. Where a fund is subject to the AIFMD asset stripping restrictions, it is imperative to confirm that any planned extractions of funds are permitted under the rules. The obvious circumstances in which this may apply are:

– Up-streaming cash to service debt;

– Repatriation of cash via regular dividend streams (e.g. for infrastructure investments);

– Returning cash to investors in partial disposals via dividend recapitalisations.

## Increased AIFMD reporting requirements in the UK

At the start of 2017, the FCA published amendments to its rules and guidance on Annex IV reporting under the AIFMD. The amendments came into force on 29 June 2017.

The reporting requirements have now been extended to include fund managers established outside the European Economic Area (non-EEA AIFMs) and which market feeder AIFs in the UK under the AIFMD national private placement regime, as well as submitting Annex IV reports for these feeder AIFs on a quarterly basis. These non-EEA AIFMs are now required also to report quarterly information on the feeder AIF's master AIF, even where the master AIF has not been registered for marketing in the UK. However, if the AIFM of the feeder AIF differs from the master AIF, the additional reporting requirement will not apply, even if the AIFMs of the respective feeder and master are affiliated.

The FCA has contacted those non-EEA AIFMs affected by the changes, with the first quarterly Annex IV reports due to have been submitted to the FCA by 31 July 2017. AIFMs affected by the new requirements should already have taken appropriate steps to ensure that the required information will be reported within the correct time frames.

The changes now bring the UK's rules and guidance on Annex IV reporting in line with existing ESMA guidance.

The changes to the rules are of most relevance to non-EEA AIFMs that market feeder AIFs in the UK under the AIFMD national private placement regime and who therefore need to ask whether the FCA's reporting requirements apply to their master-feeder.

– Does the non-EEA AIFM currently have to submit quarterly Annex IV reports for its feeder AIF? If not, then the additional master AIF reporting requirements should not apply.

– Are the feeder AIF and its master AIF managed by the same AIFM? If not, then the additional master AIF reporting requirements will not apply.

– If, however, the answer is 'yes' to either of the above, then the new requirements will apply and appropriate measures should have been taken by the AIFM to comply with them.

## The AIFMD, post-Brexit

Brexit is likely to change the landscape dramatically for the UK's alternative investment managers.

Top of the list will be the loss of the marketing passport, which currently allows the distribution of AIFs around Europe to professional investors, provided both the AIF and the AIFM are in the EU/EEA.

“The greatest impact of the AIFMD in the private equity/venture capital sector has been through its asset stripping rules

The non-EU passports in the Directive have still not been activated, although they were intended to be launched by July 2016, meaning that UK AIFMs and UK AIFs will have to comply with the national private placements regimes (NPPR). Not all member States have such regimes and those that do exist tend to be more restrictive than the UK's NPPR.

Although ESMA has already reported to the European Commission that a number of non-EEA jurisdictions meet the AIFMD "third country" requirements, the European Commission has not yet introduced passports for those jurisdictions and ESMA would have to undertake a separate assessment on the UK. A loss of passporting rights would put UK AIFMs and AIFs in the same position as US managers and others outside the EEA.

This may drive demand for the set-up of a legal presence and funds in alternative jurisdictions such as Luxembourg or Dublin. However, the requirements for adequate substance and minimum capital may cause UK AIFMs to think twice about such a move. It is likely that some AIFMs will look to third-party management companies – as US managers have done. That could serve as an intermediary solution allowing access to the EU, although even this may be a less attractive option going forward. ESMA has called for delegation practices to be reviewed, including the extent to which key functions are delegated outside the EEA.

We recommend that developments around Brexit are monitored and we will provide updates as the situation develops.

## Practical implications of the AIFMD in a Private Equity context

The rules should not restrict distributions of pre-acquisition profits where sufficient distributable reserves exist. Nor should they restrict the payment of service or management charges or interest. These payments may be used as an alternative to distributions to upstream cash. Payments for group relief surrenders should also be permitted. Introducing leverage into the target as part of the acquisition, for example, by refinancing existing debt in the target company, can provide a future route to upstream cash to service acquisition debt. This emphasises the need to ensure any debt pushdown exercise also considers future repatriation.

It may also be possible to make upstream loans, in order to either service debt or distribute cash to the shareholders. However, local financial assistance rules would need to be considered to ensure this is possible. If the company making the loan is a UK close company, the loans to participator rules should also be considered. Care will need to be taken, where an upstream loan is made and proceeds are ultimately passed to shareholders, that the relevant tax implications of such loans are considered well in advance of any such transaction.

Where regular cash extraction is expected or required, further consideration may be needed when structuring an investment. As well as the making of upstream loans, the rules do not apply to the repayment of loans. This may be of interest to infrastructure funds, which normally expect to receive regular distributions. To the extent that the need to make payments in the first two years is greater than the profits forecast, the initial acquisition could be funded with debt, sufficient that the debt can be repaid as required to return cash. However, note that distributions out of post-acquisition profits should still be allowed. In this case, there may be timing issues to consider as to when those profits can legally be distributed.

One particular circumstance that may be restricted by the rules is the ability to make part disposals in the initial two-year period following an acquisition, where that disposal may result in a distribution of cash to shareholders. If this part disposal is known or expected in advance (e.g. if a division is due to be sold on), part of the funding could be structured as a shareholder loan to be repaid with the cash from the disposal. However, where there is an unplanned disposal, it may be harder to repatriate the funds whilst leaving the group with the desired capital structure going forward.

Overall, the possibility of making distributions in the first two years of ownership, either to service debt or extract cash, may be limited in certain circumstances for firms subject to the AIFMD. Firms should, therefore, at the time of acquisition, focus on their future plans for the business and consider the impact of the rules, adapting their structures (where possible) to minimise the impact.

> "Brexit is likely to change the landscape dramatically for the UK's alternative investment managers

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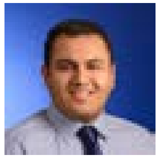

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# ATAD 2 impact for Luxembourg-based private equity funds

On 29 May 2017, the Council of the EU unanimously adopted the Council Directive amending Directive (EU) 2016/1164[1] regarding hybrid mismatches with third countries (ATAD 2). Tax experts Giuliano Bidoli and Sophie Richard explain the background and what it means for private equity funds using Luxembourg as a hub.

## What is ATAD 2?

ATAD 2 builds on the provisions of ATAD 1, which contained measures to prevent hybrid mismatches between EU Member States (MSs). ATAD 2 now also includes hybrid mismatches with third countries and adds cases not covered by ATAD 1.

Member States have until 31 December 2019 to transpose the ATAD 2 provisions, ready to be applied from 1 January 2020. Measures on reverse hybrids will need to be transposed before 31 December 2021 with effect from 1 January 2022.

## Why was it introduced?

The aim of ATAD 2 is to implement measures on hybrid mismatches consistent with the rules recommended by the OECD BEPS report on Action 2. ATAD 2 includes additional measures from the BEPS Action 2 report, and provides for secondary rules, which were not necessary in an intra-EU context. It expressly refers to the BEPS Action 2 recommendations as a source of illustration or interpretation, in so far as they are consistent with the provisions contained in the directive.

## What does the new directive cover?

ATAD 2 extends the scope of ATAD1 which applied to situations of double deduction or deduction without inclusion resulting from the use of hybrid financial instruments or hybrid entities. The new directive now also includes situations involving permanent establishments, reverse hybrids, imported mismatches, hybrid transfers, and dual residence.

The directive applies to all taxpayers subject to corporate tax in one or more MSs, including the permanent establishments (PEs) in one or more MSs of entities resident for tax purposes in a third country. The rules on reverse hybrid mismatches also apply to entities treated as transparent for tax purposes by a MS.

> "The aim of ATAD 2 is to implement measures on hybrid mismatches consistent with the rules recommended by the OECD BEPS report on Action 2

[1] ATAD 1 was adopted on 12 July 2016.

A hybrid mismatch will generally arise in situations:

- Between associated enterprises
- Between the head office and the PE
- Between two or more PEs of the same entity or under a structured arrangement.

The term "associated enterprises" generally encompasses a minimum participation of 25%, including voting rights, capital and profit entitlement. This percentage is increased to 50% in cases involving hybrid mismatches that result from payments to or by a hybrid entity, payment to an entity with one or more PEs, payment to a disregarded PE, deemed payment between a head office and a PE or between two PEs, double deduction, imported mismatches, and reverse hybrid mismatches.

The rule also covers a person who acts together with another person in respect of the voting rights or capital ownership of an entity. That person shall be treated as holding a participation in all of the voting rights or capital ownership of that entity that the other person holds. There is no further detail included in ATAD 2 to understand the exact scope. Referring to BEPS Action 2 report (recommendation 11.3), the rule could, for example, target the case of an investment vehicle where its interests, held by various minority shareholders, are managed by the same person.

## The possible impact on Luxembourg structures

The private equity sector is particularly affected by the rules applying to payments made under a financial instrument involving a deduction without inclusion. The rule foresees that the EU payer will have to deny the deduction if the payment is not included within a reasonable period of time and if the mismatch outcome is attributable to differences in the characterisation of the instrument or the payment made under it. The payment will be treated as included within a reasonable period of time if:

- It is included by the jurisdiction of the payee in a tax period that starts within 12 months of the end of the payer's tax period;
- It is reasonable to expect that the payment will be included by the jurisdiction of the payee in a future tax period and the terms of payment are at arm's length.

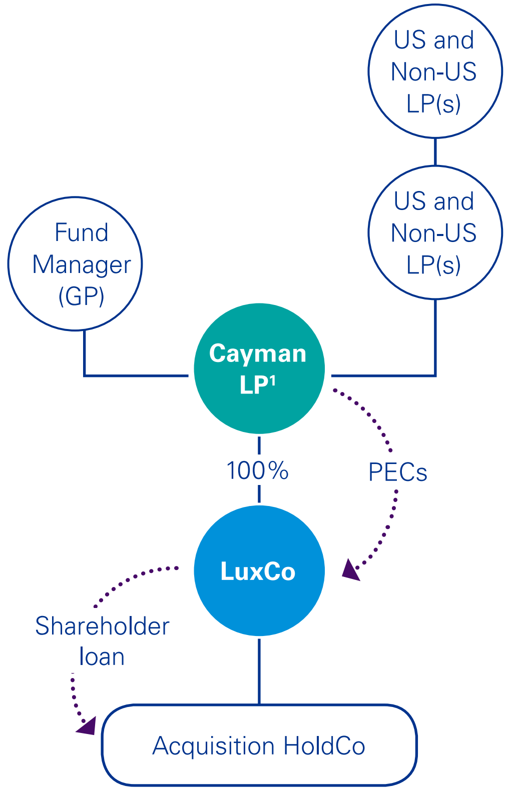
Close attention should also be paid to the imported mismatch rules where, for instance, a loan granted to an EU target company is funded by a loan between its non-EU parent company and another non-EU group company. Where this situation causes a hybrid mismatch – and the non-EU jurisdictions do not provide for any remedy – the rule spells out that the EU target company should deny the deduction to the extent of the mismatch.

## The anti-hybrid mismatch rules in practice

Luxembourg is a well-known holding location and, over the past two decades, has become the jurisdiction of choice for many private equity funds, due to the location of the funds and the structuring and financing of acquisitions.

It is, therefore, important to understand if and how ATAD 2 will have an impact on the typical tried-and-tested structures and instruments issued by Luxembourg companies for financing such acquisitions.

Take the following example:




> "Luxembourg is a well-known holding location and, over the past two decades, has become the jurisdiction of choice for many private equity funds, due to the location of the funds and the structuring and financing of acquisitions

[1] ATAD 1 was adopted on 12 July 2016.

The investment vehicle, a Cayman limited partnership (LP), will use one of its Luxembourg subsidiaries as the investment platform. The funding is provided by a Cayman LP to the Luxembourg company in the form of ordinary shares, split into various classes to be used to finance the acquisition of the shares held in Acquisition HoldCo. Moreover, the Luxembourg company will grant a shareholder loan to its target which is financed by Preferred Equity Certificates (PECs). Interest payments under the PECs funding the shareholder loans should in general be tax-deductible in Luxembourg, while it is expected that the Cayman LP would not be subject to tax on its income.

We have recently advised on a similar case, where the rules were found to have a limited impact to the extent that the Cayman LP was a tax-exempt vehicle. Indeed, the preamble in ATAD 2 clearly states that ***a payment under a financial instrument should not, however, be treated as giving rise to a hybrid mismatch where the tax relief granted in the payee jurisdiction is solely due to the tax status of the payee or the fact that the instrument is held subject to the terms of a special regime***.

On the other hand, the rule may have an impact in certain cases where the look-through approach of the BEPS 2 report is considered – for instance, for US investors and where the payment leads to a hybrid mismatch at their level. However, the US investors would additionally need to be considered associated enterprises or to be acting under a structured arrangement, as detailed above.

Additionally, ATAD 2 clearly states that the instrument (in this case the PEC instrument) would not be considered as a hybrid instrument, provided it is reasonable to expect that:

– The payment will be included by the jurisdiction of the payee in a future tax period;

– The terms of payment are at arm's length.

As the PEC mainly finances the shareholder loan, the intra-group financing activity will be supported by a transfer pricing study in Luxembourg. This would confirm that the terms of payment under the PECs – including the interest rate – are at arm's length. Finally, one would have to consider the potential impact of any imported mismatch rules at the level of the target company.

Convertible Preferred Equity Certificates (CPECs) are instruments through which private equity funds can fund Luxembourg companies used to acquire shares in a target company. The income – dividends, capital gains or liquidation proceeds – should be tax exempt at the level of the Luxembourg company: the application of the participation exemption regime makes the non-deduction of the CPECs redemption tax-neutral. In these circumstances, therefore, there should be no impact at the level of the Luxembourg company.

## Keeping a close eye

Given the complexity of ATAD 2, and the lack of detail provided so far, its implementation in each member state will need to be closely monitored.

Nevertheless, firms should start reviewing the potential impact of ATAD 2 on their existing structures immediately – and whether some degree of restructuring might be necessary. That calls for a thorough understanding of the tax treatment of each investor and each entity and, in particular, the potential impact of relevant mismatch rules.

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