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UPDATE

Summary of Jersey Funds Updater (18 January)

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Speakers from our team shared the latest market insights arising out of a very busy end to 2018 and an uncertain 2019, as well as providing an update on the key domestic and international legal, regulatory and tax developments impacting the funds industry – not least the impact of economic substance changes, NRCGT and BREXIT.

Jersey Finance Update

We were delighted to have Lisa Springate, Head of Technical from Jersey Finance, as our guest speaker, covering a number of topics which included: a brief look back on 2018, insights on what the year ahead and Jersey Finance funds related activity planned for the forthcoming year. To view Lisa's slides please click here.

Market Conditions (2018/19)

Global private fund raising in 2018: data sourced from Preqin confirmed that 2018 will not quite match the record fundraising in 2017, although 2018 saw more money raised than in any other year other than 2017.

Global private fund raising in 2019: Preqin indicates that the market for private funds remains buoyant, with fund managers anticipating strong appetite from investors in 2019 despite market correction concerns; large proportions of investors across the asset classes will commit more capital in 2019 than in 2018, often focussing on established managers. Preqin has confirmed the pre-eminence of 'Mega Funds', with funds seeking to become the largest private equity, venture capital, real estate, infrastructure and secondaries vehicles currently in the market and 17 of those mega funds currently each seeking $10billion or more from investors.

Global private equity fund raising trends: 2018 saw fewer private equity funds raised less than the vintage year of 2017 (1,175 in 2018 vs 1,670 in 2017) but the average global PE fund size increased in 2018: $363mn in 2018 versus $339mn in 2017 – that's the highest level since 2007's peak average of $422mn. Preqin data suggests that as at 1 January 2019 there are 3,750 PE funds in market, seeking a total of $977bn. The five largest private equity funds in the market are seeking a combined $219bn. This also evidences capital concentration at the top end of market.

A quote worth sharing from Preqin's Christopher Elvin, Head of Private equity:

> "*Private equity fundraising is increasingly a two-tier market. Billion-dollar funds accounted for two-thirds of all capital in 2018, and most of the largest fund managers say that they are routinely oversubscribed. Although investor appetite for smaller funds exists, with concerns regarding a market correction, the bifurcation between smaller managers and larger managers is likely to become more pronounced in the months to come.*"

The wall of dry powder keeps building, but market uncertainties are starting to soften deal pricing.

Interestingly, 2018 also saw more Asian private equity funds raised than European funds for the first time, (although Europe's overall global share was $90bn versus $80bn for Asia and (for context) $240bn for North America), underlining the importance of JFL's global diversification strategy.

UK Real Estate:

Against the mixed backdrop of a welcome NRCGT outcome (see below) and Brexit and related political uncertainty, a lot of investors are not transacting at the moment but we are still seeing activity from international (particularly Asian, US and Middle Eastern) investors, taking a long-term post-Brexit view and capitalising on the low sterling rate and competitive UK pricing relative to mainland Europe, which has seen rental growth across more sectors.

There are some positive signs in the UK industrial sector (seeing growth in yield and rental income and with good quality industrial property holding its value) and in the UK office sector (particularly in London and some regional areas, with continuing rental growth, but a thinner market for acquisitions and availability of new office space challenging secondary space). There is a general feeling that the UK retail sector is struggling, particularly high street and secondary shopping centres, given the increase in online sales and big 'anchor tenant' retailers commanding rental discounts. Student accommodation, a strong growth area in recent years, is starting to face challenges, given some over-supply, a relatively costly letting and management model and recent media attention on the price of student accommodation creating pressure to reduce rents.

AIFMD – Publication of EC Report

In December 2018 the European Commission published its report (prepared on the basis of KPMG survey work) on the Operation of AIFMD, which can be found here:

https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190110-aifmd-operation-report_en.pdf

In short, the key findings are that AIFMD has played major role in helping create an internal market for AIFs and a harmonised and stringent regulatory and supervisory framework for AIFMs in the EU, but some provisions may counter those aims as regards achieving the key principles of effectiveness and efficiency. The report highlights the following challenging factors in particular:

- national inconsistencies re the treatment of sub-threshold AIFMs and their reporting requirements
- the need to harmonise leverage calculation methodologies (perhaps by reference to emerging new IOSCO global principles - the report notes the use of leverage by AIFs is rare)
- external valuation rules vary nationally
- a lack of coherence between the remuneration rules and other pieces of legislation and guidelines
- the functional separation of risk and portfolio management may be inappropriate for smaller managers
- differing national interpretations of depository rules (e.g. the extent of cash monitoring duties)
- AIFMD's disclosure requirements may be excessive for non-retail investors
- the notification provisions relating to investment in non-listed EU companies are overly burdensome

As regards EU marketing there are some useful outputs. EU passporting for EU AIFMs seems to be working well, but is suffering from the different approaches taken by national regulators (e.g. differing 'marketing' definitions). The EU's proposed harmonising Omnibus Cross Border Distribution Regulation is designed to improve this area.

As regards the use of NPPRs by non-EU AIFs and AIFMs, the report notes the variance across Member State NPPRs and the differing demand for non-EU AIFs across Member States. Given this variance, respondents confirmed it is of 'added value' to the EU that NPPRs are permitted to operate, whilst some called for the non-EU passport to be introduced and significant number, from a range of Member States and 3rd countries, called for NPPRs to be retained, even if a non-EU AIFM passport is introduced. Since it's likely Brexit will continue to delay the non-EU AIFM passport, the retention of NPPRs in the longer term in AIFMD II would be welcomed but query whether we will also see a possible tightening of 3rd country tax compliance requirements in AIFMD II, beyond tax co-operation and into economic substance, an area where Jersey should fare well relative to other domiciles.

Brexit

With the continued uncertainty around Brexit, it's important to remind clients that Jersey is and will continue to be a 3rd country under EU financial services regulation through and beyond any Brexit. Future EU regulations will have no impact to Jersey unless they have a 3rd country element and Jersey seeks to reflect them in local legislation as part of its 'good neighbour' policy and where appropriate/beneficial for continued EU market access (e.g. AIFMD marketing and economic substance). Brexit may present both opportunities and threats:

Opportunities:

- UK becoming part of the 'rest of world' investor universe, with potentially reduced AIFMD implications if it loosens its NPPR
- Doubling down (alongside UK) on 'rest of world' opportunities
- Jersey's ability to offer cheaper/quicker structuring options relative to EU centres (see JPF success)
- No direct reliance on contrived DTA arrangements (eg hybrid instruments)
- Future EU regulation (eg AIFMD II) will not tempered by the UK's benign and pragmatic influence

Threats:

- Loss of UK's protective voice where the EU considers policy in relation to the CDOTs (eg economic substance….)
- More scope for unilateral, negative EU action by Member States (cf recent Dutch black-listing of low tax centres)?

Non-Resident Capital Gains Tax (NRCGT)

The proposed NRCGT regime, which will impose UK tax on capital gains made by non-UK residents disposing of UK commercial property or substantial interests in UK 'property rich' vehicles from April 2019, has seen further refinements over the last 3 months.

Whilst the draft legislation has been subject to consultation uncertainty has surrounded the treatment of non-residents investing through 'collective investment vehicles' (whether a JPUT or more widely-held Jersey real estate fund (collectively referred to as 'CIVs')) and how they will be taxed under the regime.

Jersey CIVs are in common use and are attractive because they are generally transparent for UK income tax, they facilitate stamp duty land tax-efficient investment and they have historically not borne UK CGT. As such, they have been particularly beneficial for tax exempt investors, such as pension funds, investing in UK commercial property. Concerns had been voiced that the new NRCGT regime could add extra layers of tax for such investors, with a CIV being charged to CGT on a property disposal and its investors not benefitting from their usual tax exemptions. Exemptions offered to certain UK fund vehicles were not initially extended to non-UK resident funds.

What has now been confirmed is that the "default position" for a non-UK resident CIV beyond April 2019 is that it will be treated as a company - ie "opaque" and chargeable to CGT. However, the good news is that HMRC and HMT have confirmed that a non-UK resident CIV will be able to change that default position by making one of two possible elections.

The first is a 'transparency' election that will allow a less widely-held CIV (e.g. such as a JPUT) that is already transparent for income purposes to opt to be treated as a partnership (ie transparent) for the purposes of UK tax on capital gains. This would mean that any disposal of UK property will not be taxed within the JPUT, but will be taxed in the hands of the JPUT's unitholders, subject to any exemptions that they may enjoy. This election requires the consent of all unitholders and will be irrevocable.

The second election is an 'exemption' election available to more widely-held CIVs (eg. a Jersey real estate fund). If certain conditions are met, this will allow the CIV to elect that it (and all its subsidiary entities) be exempt from UK tax on gains, with any NRCGT applied at investor level – there will be additional HMRC reporting obligations for CIV managers under this regime. This election is at the discretion of the fund's manager, but is revocable.

Managers (or managing trustees) of Jersey CIVs need to reach out to the promoter of each CIV, analyse their investor base (ie are they tax exempt and are they likely to consent, where necessary) and take UK tax advice, to determine whether and how an election could be made, ideally in advance of April 2019.

Our session explored some of the factors likely to influence the election decisions of managers of Jersey CIVs, the relative advantages of the two elections and possible restructuring solutions for some potentially opaque structures.

The announcement of these election mechanisms is good news for Jersey and the continuing utility of JPUTs and Jersey real estate funds. The transparency election should ensure that investors in JPUTs making this election should, at least, not be in a worse position when compared to holding the property directly or through a partnership. The exemption election, if available, will level the playing-field for Jersey real estate funds with a wider investor base.

Panel Session, Moderated by Felicia de Laat, Mourant LP Partner

Our experts shared their views on a variety of topics including:

- recent developments in relation to economic substance
- proposed changes to the Codes of Practice
- proposed changes to the COBO regime and;
- the recent blacklisting imposed by the Netherlands

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