A matter of substance - an objective look at a subjective issue

The introduction of the Alternative Investment Fund Managers Directive (AIFMD) has led to more focus and discussion on the subject of ‘substance’. Of course, the matter of substance was important before AIFMD came into being owing to its importance to investment managers and, by implication, to investors from a tax perspective. While there are one or two definitions of substance, which differ depending on whether the definition relates to AIFMD or tax requirements, there remains a very sizeable subjective element to the definition.

According to David Waldron of PricewaterhouseCoopers CI LLP, from a corporate tax perspective the concept of substance appears in two areas; the first relates to residency and central management and control tests, while the second relates to transfer pricing.

“While the implementation of residency and central management and control tests has come under scrutiny from tax authorities in recent years, the underlying concepts remain fundamentally the same,” he says. This is in contrast to the concept of substance in the context of transfer pricing, which has seen a significant shift.

BEPS & tax considerations

The OECD’s Base Erosion and Profit Shifting (BEPS) project has sought to address weaknesses in existing international tax rules which have historically created opportunities for BEPS. The project is based on 15 actions across three key ‘pillars’; one of which is ‘reinforcing substance requirements in the existing international standards’[1].

Mr Waldron advises that, “with this in mind, substance is a theme throughout the BEPS project, but it is specifically addressed from a transfer pricing perspective in the Actions 8-10 report (Aligning Transfer Pricing outcomes with Value Creation) which represents a re-write of certain sections of the 2010 OECD Guidelines”.

The report addresses the potential issue of a misalignment between ‘contract’ and ‘conduct’ (emphasising the importance of the latter) and stipulates that a return for risk should be attributed to the entity that both controls and has the capacity to assume the risk. It also provides greater clarity about what this means in practice through examples of conditions that need to be met to evidence assumption and control of risk. Mr Waldron says that, for example, decision makers need to: understand the risk based on a relevant analysis of the information required for assessing the foreseeable downside and upside risk outcomes of such a decision and the consequences for the business; have the competence and experience in the area of the particular risk and have an understanding of the impact on the business; and have access to relevant information either by gathering the information themselves or through sub-contractors[2].

In scenarios where activities, such as information gathering or day-to-day risk mitigation, are outsourced the risk owner must determine the objectives of these activities; hire the sub-contractor;

---

[1] Addressing Base Erosion and Profit Shifting, February 2013
[2] Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports: Revisions to Section D of Chapter I of the Transfer Pricing Guidelines (1.66)

assess if objectives are met; and have the capacity to make decisions about whether to adapt or terminate the contract.[3]

AIFMD & substance

AIFMD brought additional focus to the question of substance; the capability and functionality of the alternative investment fund manager (AIFM). AIFMD does have its own definition and sets out a set of substance requirements. The key requirements being to 'not delegate portfolio or risk management to the depositary or delegate to any entity with a conflict unless such entity is functionally and hierarchically separate… conflicts of interest identified and managed', and to 'not delegate functions to the extent that it becomes a letterbox entity'.

In essence, this boils down to the fact 'that the AIFM must not delegate its functions to the extent that, in essence, it can no longer be considered to be an AIFM of the alternative investment fund (AIF) and to the extent that it becomes a letterbox entity'. In order to operate as an AIFMD an AIFM must perform its own investment management services with the required expertise, resources and oversight from decision-makers.

AIFMD defines a letterbox entity (i.e. a lack of substance) as any of the following four instances, or a combination thereof:

- An AIFM that no longer has the necessary expertise and resources to undertake its delegated tasks and manage the risks associated;
- An AIFM that loses power to take the decisions of senior staff;
- An AIFM that loses the rights to interact with its delegates; and
- An AIFM that delegates the performance of investment management

However, as we have already discussed the matter of substance is not just an AIFMD issue.

Managers domiciled in Guernsey have a choice as to whether they 'opt in' or remain outside the AIFMD equivalent regime (the 'Dual Regime'). Being 'out' still requires managers to have substance in Guernsey from a tax perspective. As a domicile Guernsey offers managers considerable flexibility; aside from being able to 'opt out' of the AIFMD classification (which most managers will want to do if they are not fundraising in the EU), managers can choose whether they have a management company per investment structure (thereby potentially keeping below the funds under management threshold), a 'Super ManCo' acting as a manager for multiple investment structures or having the investment company self-managed. Added to this, Guernsey domiciled managers have the flexibility of using Guernsey's outsourcing regime. The outsourcing regime, together with the Dual Regime, offers managers considerable flexibility as to how they best comply using a business model that fits with their existing organisation and structure. This will translate into cost savings for the manager.

For managers opting into AIFMD, the definition of substance does provide guidance as to what is required. Managers can be responsible for both risk and portfolio management themselves or outsource one of these key functions. Outsourcing still means the board of the AIFM (or if self-managed, the investment company itself) retains responsibility for the ownership and management

[3] Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports: Revisions to Section D of Chapter I of the Transfer Pricing Guidelines (1.65)

of the outsourced function. Ongoing review of the performance and the quality of the outsourced service remains the responsibility of the board making the appointment. Guernsey service providers are adept at managing such relationships through service level agreements and key indicator performance reports.

Christopher Jehan, of Midshore Consulting Limited, advises that even in the case where the management company is physically established and staffed in Guernsey the actual performance of both portfolio management and risk management may be outsourced via an investment management agreement to the parent or an affiliate of the management company. In addition to the board performing regular reviews of reporting such management companies, some may have additional staff performing more frequent in-house reviews of the activities of their affiliates.

"Local presence of the management company can also provide support for other jurisdictions, such as a Guernsey-based manager being the fund manager for a Mauritian fund where the investment management group has no staff (and therefore no substance) in Mauritius," he says. According to Mr Jehan such arrangements are particularly useful under AIFMD to avoid a non-European fund inadvertently being classified as a non-EU AIF being operated by an EU AIFM.

Corporate governance

Of course, substance is nothing without effective corporate governance. Gavin Farrell, of Ferbrache & Farrell LLP, points out while Guernsey companies' law does not legislate for corporate governance, this being left to general principles and the Common law, there is a statutory duty placed on a board by the 2008 law to manage the business and affairs of a company or to direct or supervise it. That intimates that a board needs to take positive and effective actions to manage or direct the company. Not to do so may mean that the board is passive and not managing the affairs; which recent decisions from the Guernsey Financial Services Commission (GFSC) have shown as being failures resulting in potential regulatory sanctions.

"To have an effective management will be synonymous with substance. Or to put it the other way, substance will be proven by an effective board, and not simply by having a board in place regardless of its level of activities," says Mr Farrell.

The age old concept of substance over form has continuously been a requirement and not just in tax or regulatory affairs. It has its genesis in corporate governance. A board is there to manage the affairs of a company; "To do so requires tangible solid presence, and hence substance. The other substance requirements, such as BEPs, central management and AIFMD, all stem from there," adds Mr Farrell.

He goes on to point out that one of the common threads linking the various codes on corporate governance, including the UK corporate governance code, AIC code or our GFSC code of corporate governance, is the requirement for an effective board. Generally, in order to be effective a board needs to be present, determine matters and be seen as taking actions.

Pursuant to guidance issued by the Financial Reporting Council (FRC) on board effectiveness for the UK code purposes, boards will need to devote sufficient time to discharge their responsibilities effectively, will need to make well-informed and high-quality decisions, will be accountable and will need to challenge.

The FRC further clarifies that well-informed and high-quality decisions will be engendered by allowing time for debate and challenges, among other factors. As the FRC explains, appointing directors who are able to make a positive contribution is one of the key elements of board effectiveness. The AIC Code also summarises that every company should be headed by an effective board. The GFSC Code itself sets out that boards should meet sufficiently often to discharge their duties in an effective manner.
“A board which follows the principles of regular, open and effective discussions and decision-making processes will by its very nature have, and be seen as having, substance in its corporate governance,” says Farrell. “That in turn will support all the other requirements for substance.”

Conclusion

For managers ‘opting in’ under Guernsey’s Dual Regime, an AIFMD-compliant structure needs to demonstrate substance from both an AIFM and tax perspective. The composition of the board of the manager is of critical importance.

Given Guernsey’s position as a leading alternative investment funds domicile, it can be challenging to source investment expertise for some asset classes. However, investment expertise is available from Guernsey’s deep pool of resident non-executive directors and the flexibility afforded by the Dual Regime and the outsourcing regime means that, for example, management companies and self-managed investment companies can form investment committees to which they can appoint members with the specific asset class expertise.

This is a useful tool in being able to juggle what, at times, may be conflicting tax and AIFMD substance requirements.

This article was written by Robin Fuller of Guernsey Funds Consultancy on behalf of the Guernsey Investment Fund Association.

RF
16.02.2017