

By 2020, how an asset management firm deals with tax risk will be viewed as a competitive advantage or disadvantage. Investors will expect robust and efficient tax infrastructure and will have minimal tolerance of tax uncertainty or tax adjustments. As a result, tax will be a key operational and business activity, requiring specialist resources, a new approach and integration into front, back and middle office activities. So what will be the drivers for this new global tax world? And how will investment firms transform to meet these challenges as the industry becomes an even more significant part of the financial services sector?

Asset Management 2020 and beyond

Transforming your business for a new global tax world

Report





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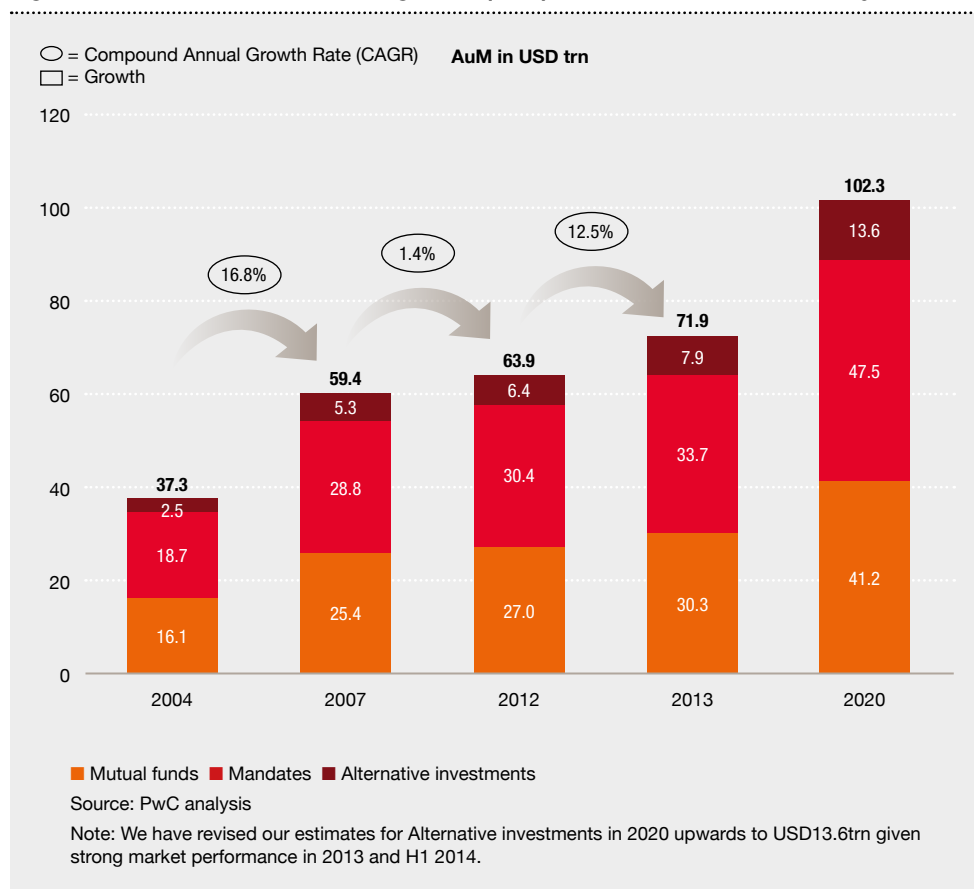
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Introduction

By 2020, how an asset management firm deals with tax risk will be viewed as a competitive advantage or disadvantage. Investors will expect robust and efficient tax infrastructure and will have minimal tolerance of tax uncertainty or tax adjustments. As a result, tax will be a key operational and business activity, requiring specialist resources, a new approach and integration into front, back and middle office activities. So what will be the drivers for this new global tax world? And how will investment firms transform to meet these challenges as the industry becomes an even more significant part of the financial services sector?



Figure 1: Global Assets under management (AuM) to reach above USD100trn by 2020

Tax should not be considered solely as a risk to manage – it is also an opportunity.

While the asset management industry will grow rapidly in the coming years (see Figure 1), growth for individual asset management firms will not be automatic. The risks will change, as the tax and regulatory environments continue to develop. Tax, in particular, will be a key operational and business activity, requiring specialist resources, a new approach, and integration into front and middle office activities – including data reporting, product development, distribution and brand strategy. Tax and reputation will be inseparable concepts. Taxes will now be viewed as an operational risk, joining the ranks of other key risks which senior management takes a keen interest in, and one that needs a strategically planned risk management programme integrated into all aspects of their business operations. How a firm deals with tax risk will be viewed as a competitive advantage or disadvantage.

In 2020, investors' expectations will include a robust and efficient tax infrastructure. And zero tolerance of tax uncertainty or tax adjustments. In addition, as many countries struggle with deficit reduction and the need to invest, the whole of the financial services industry, including asset management, will be expected to play its part in policing the global financial system and ensuring that tax authorities have the correct tax information on taxpayers.

Total transparency of investor residency and identity will be the norm. Asset managers will have to demonstrate the highest standards of anti-money laundering (AML) and know-your-customer (KYC) responsibilities, plus reporting to tax authorities and to taxpayers on the returns flowing from their funds. Politicians, regulators, the media and the public will all expect nothing less.

However, tax should not be considered solely as a risk to manage – it is also an opportunity. Managing tax risks and leakages well at all levels (investments, funds and investors) can distinguish asset managers from their peers. While managers have traditionally been tasked with generating performance 'alpha' for their investors, 'service alpha' in 2020 will be a key differentiator. The concept of service alpha implies an entirely new challenge for asset managers: how to communicate with investors about tax matters. Service alpha will require the asset manager to first explain it and then help investors recognise its benefits.

To help asset managers plan for the future, in the last section of this paper PwC has set out a vision of what the tax landscape should look like in 2020 to adequately address the new tax environment.

The issues addressed by the CEO of our fictional firm, Investar Asset Management¹ (on page 6 and throughout our paper) give an indication of the challenges the industry faces in putting the management of tax risk at the heart of all strategic business change.

¹ None of the information or facts about the fictional investment firm, Investar Asset Management, are sourced from PwC clients or PwC client engagements. The examples have been developed solely to illustrate key points in this paper.

Sunday



From: Angus Moreland, CEO, Investar Asset Management

To: All department heads

CC: Charlene Ho, Head of Tax, Investar Asset Management

Date: Sunday 22 March 2020 15.00

Subject: Preparing for the week ahead

Dear all.

Apologies for emailing on a Sunday night, but we've got a big week ahead. As we strive to be a cutting-edge global asset management business, we are moving forward with a raft of new products, new distribution opportunities, changes in performance reporting and an overhaul of our global technology platform. Each of these developments has tax implications, so please run all initiatives past Charlene before you action them.

Events during the past week illustrate perfectly why this is critical.

Two new product offerings to pension funds were launched after almost a year of intensive work with great success. Increased certainty on the funds' withholding and capital gains tax risks and leakage has attracted much interest and commitments. Great stuff!

Unfortunately, Charlene had to spend a significant amount of time to get one of our fund directors out of serious trouble with some tax administrations in Asia. Tax compliance for your products is not only a matter for the specialists at headquarters; the situation in Asia illustrates that you can run into tax trouble personally if your products fail to comply with local tax rules.

I would also like to emphasise that the use of the Travel Tracker system is an obligation for everyone – uncoordinated and uncontrolled travelling around the world can put you and our company at risk.

If we all work together, we can capitalise on this new tax environment, and use our superior infrastructure as a competitive advantage.

Regards

Angus.





By 2020 tax and reputation will be inseparable concepts. Taxes will be viewed as an operational risk, joining the ranks of other key risks which senior management takes a keen interest in, and one that needs a strategically planned risk management programme integrated into all aspects of their business operations.

Executive summary

Asset managers adapt to new role at centre stage

As banks and insurers retreat from many investment business lines, asset managers will be more influential across a range of products by 2020. A new breed of global mega-managers will attract huge focus from tax authorities, which will have specialist teams with the capabilities to carry out much more detailed enquiries than in the past and the powers to request real-time investor-related information. Asset managers will respond by dispersing their strategic tax resources throughout their business operations to give front, middle and back office staff access to real-time expertise. The in-house tax team will have developed to deal with perpetual audits and to engage with tax authorities on a frequent basis to influence policy and help guide the implementation of tax rules.

Transparency: firms leave no stone unturned

Tax transparency will be a fact of life in financial markets by 2020 as the Common Reporting Standard (CRS) and global tax reporting become reality. Post the examination by the Organisation for Economic Co-operation and Development (OECD) of the basis of taxation for a permanent establishment, many tax authorities will focus on the economic nexus of an asset management contract and the ultimate investor, rather than just the physical nexus of the asset manager, its property, and its staff, in determining the location of taxation of the asset manager's business.

Through political pressure, investor demand and regulatory change, many offshore financial centre products will have moved onshore into a range of new registered products as jurisdictions and regional blocks will continue to compete to offer attractive investment vehicles for cross-border and domestic investment. Many of these onshore vehicles will themselves be tax exempt, obtain double tax treaty access and suffer no withholding tax on distributions or redemptions as countries will continue to compete to attract vital inward investment. New specialist platform investment products like securitisation regimes and real estate investment trust (REIT) funds will be created as part of this competitive landscape. All of which will bring new complexity to product design and fund structuring.





Portfolio taxation will become a key battleground

By the early 2020s, the OECD Base Erosion and Profit Shifting (BEPS) action on hybrid instruments, interest deductibility and treaty access will have led to an environment where some degree of tax leakage is a fact of life for many funds. Performance evaluation and attribution will focus predominantly on post-tax yields. Prospective investors will ask about tax disclosures even taking their individual tax charge into account before they consider investing in a fund. They will be seeking more certainty with respect to tax issues. With more transaction taxes, local withholding and self-assessment capital gains regimes, every asset purchase and sale will have to be carefully examined from a tax risk and reporting perspective, requiring asset managers to have real-time access to data on global tax regimes. When launching new products, asset managers will routinely carry out full assessments to make products competitive in all channels. Investors will gravitate towards managers that offer products reflecting investor-specific tax profiles. By 2020, a number of integrated businesses combining asset management, wealth management and private banking activities will be able to provide a full tax advisory service to clients.

Tax branding will be at the heart of marketing and reputation

By 2020 and beyond, tax will be just another operational business risk in the same way that valuation and regulatory reporting came to be viewed as operational business risks years before. Control reports over outsourced services by custodians, administrators and transfer agents will routinely include tax risk management and governance as

a core control objective. As asset managers' portfolios become larger, internal audits of the tax function will be carried out to evidence their own standard of tax risk management.

Asset managers and their clients, keen to avoid being tainted by association with inefficient and potentially inaccurate tax compliance, will have become highly proactive on the issue. Asset management PR efforts in the 2020s will focus not just on fund performance, but on tax and compliance, with detailed statements released into the public domain on tax policies, remuneration and reward structures, the amount of tax paid and where it is paid.

Tax technology will be key to performance and client satisfaction

By 2020 and beyond, the overwhelming trend will be to move the tax process to a technology-enabled environment that connects existing technologies to tax-sensitised databases that are connected via a centralised tax data hub. Technology for tax will enable investment firms to make timely tax-informed investment decisions and provide investors and tax authorities with the transparency and reporting that they demand. It will also enable tax uncertainty minimisation. Technology will also create the ability to differentiate between the alpha created by the portfolio manager and the alpha created (indirectly) by the capability of the tax team to manage tax leakage and tax risk.

Funds that demonstrate tax efficiency at the fund level relative to their peers will create a distinct advantage when fundraising in a highly competitive environment. Technology tools will also enable workflow management, allowing fund managers to monitor tax



Tax authorities will request whatever information they want from asset managers through having direct access to their IT systems rather than asset managers pushing data to them.

services internally and at their service providers in real time. Technology will not only be close to the heart of asset managers – the tax authorities will have made significant investments by 2020 too. As a result, the age of selected paper-based reporting by asset managers to the tax authorities will be over – perhaps even annual reporting will be over. Tax authorities will request whatever information they want from asset managers through having direct access to their IT systems rather than asset managers pushing data to them.

The tax function of the future

As a result of these considerable changes to the tax environment, the tax function in 2020 and beyond will be significantly different from what we know today. The tax function will play a key role in the day-to-day management of operational risks and will no longer only deliver compliance and make tax technical assessments. The assessment of complex data and its implication in business and product development decisions will be the new normal. Consequently, the profile and composition of the tax function will have changed. It will be critical for asset managers to decide to what extent they want to rely on internal sources. The increased complexity of the tax function will require that it spends significant periods of time with operational activities in order to be able to act as a trusted adviser internally and to key executives.

Asset managers will need to ensure that highly skilled tax people are brought into the heart of the business. The tone needs to be set at the top. The tax function is critical to the entire operation and senior management will need to make sure that this is well understood throughout the ranks.





The tax game changers

The landscape for asset managers in the coming years is set for radical change. This change was set out in a paper PwC published in early 2014 – Asset Management 2020: A Brave New World² – which predicted the global trends impacting the industry in the coming years and identified their consequences. These trends included a huge rise in assets and fundamental changes in the investor base, while cost pressures rose. Significantly for the tax function, there would be a step-change increase in transparency, changing the perception of tax and making it a key operational issue.

So what do these predicted shifts mean for the evolution of tax processes that will allow firms to survive and remain competitive in the years to 2020 and beyond?

To find out, let's take a look at a week in the life of Investar Asset Management. It's Monday 16 March 2020....



Monday

Asset managers adapt to new role at centre stage



From: Charlene Ho, Head of Tax, Investar Asset Management

To: All department heads

Date: Monday 16 March 2020 07:30

Subject: Analysis of tax-related data – your help required

Dear all.

Please ensure that you assist the embedded tax specialists in each of your teams in the analysis of all tax-related data by the end of the week so that our 2019/2020 tax report is ready for audit at the end of next month. Remember that any omissions or inaccuracies may result in considerable financial and/or criminal penalties and the company being placed on the tax authorities' 'non-compliant' lists. In addition, investors are looking for tax foot faults as they consider where to invest.

I am particularly interested in seeing how we have managed the tax risks in our new Asian peer-to-peer lending platform.

Regards

Charlene.

By 2020, non-bank finance will no longer be in the shadows. Under pressure from regulators and from demands on regulatory capital, banks and insurers will have retreated to their core businesses. Asset managers will have become providers of a far broader set of products than in 2015. They will be dominant across a range of products and activities, including:

- Pension and lifetime savings products
- corporate financing, such as direct lending, trade receivables and invoice factoring
- distressed assets and commodities
- peer to-peer lending and crowd-funding
- infrastructure funding
- money market strategies.

As a result, by 2020 and beyond economies of scale will become paramount and a new breed of mega-manager will have emerged, with a footprint in all geographies and distribution channels. Some of these mega-managers will attract a great deal of focus from policymakers, regulators and tax authorities.

Equally, many new non-finance boutiques will have emerged as specialists in the new non-bank finance areas. The complexity of these strategies will attract attention from tax authorities as they look to stay abreast of industry developments.

The growing size and importance of the asset management industry means that tax authorities will be interested in every aspect of the asset management industry and its participants. Specialist teams at many tax authorities will have the capabilities to carry out much

Dealing with derivatives

The tax landscape relating to synthetic and derivative type transactions will get increasingly complex as more of these transactions become centralised on regional exchanges and tax authorities look to the underlying substance of the synthetic to determine the tax attributes of the yield. Uncertainty of treatment will create uncertain tax positions within some portfolios and funds will have to be carefully managed and positions disclosed in fund accounts. International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (GAAP) will have become aligned in this respect.



2020

Self-assessment – already common in 2015 – will have become the dominant model for global tax collection by 2020.

more detailed enquiries and asset managers will have to be able to respond. Access to records is not an issue: tax authorities will have direct access to asset managers' IT platforms. This started with VAT (SAF-T)³ and quickly became a global standard. As yet, only some global businesses are subject to perpetual tax audits across the globe by their home tax authority, with coordinated assistance from local tax authorities.

In the future, all investment activity will be reported in some way by a counter-party, financial intermediary, fintech provider or broker. Tax authorities will routinely access such data from regulators and market operators and will be able to routinely test these new non-bank finance investment areas for compliance with transaction taxes, withholding taxes and self-assessment capital gains taxes. At present, tax rules in each country have not kept pace with new investment strategies and quirks, and anomalies have to be carefully navigated to avoid tax traps.

Zero-tolerance tax environment

Self-assessment – already common in 2015 – will have become the dominant model for global tax collection by 2020. This reflects growing pressures on the tax authorities themselves. Many authorities, unable to deal with increased complexity and volumes, will have recalibrated their systems to shift the burden of calculation and tax collection to funds and fund management firms. Some tax authorities will download financial statements directly from investment firms and create automatic tax calculations.

The calculation will be either right – or wrong. Fines and penalties for wrong, late or missed self-assessments will be significant and by far exceed fines for wrong declarations as in 2015. Fines will relate to both failure to comply and failure to comply completely with information requests. It will not be enough to pay the appropriate amount of tax – the supporting information and calculations will also have to be presented in the appropriate formats.

How will asset managers respond?

The responses to far greater scrutiny will take place at a number of levels within asset management firms.

First, the huge increase in the volume of tax reporting will have put cost pressures on asset management tax team budgets. By 2020 many firms will be focusing on their tax costs and will be keen to extract more from existing resources. This places an emphasis on using technology to increase efficiency, tighten compliance procedures and avoid regulatory penalties.

Tax resource will have become more dispersed throughout the business operations of the asset manager to give front, middle and back office staff access to embedded real-time expertise and respond to tax authority demands.

The in-house tax team will have developed technology tools to deal with complying with perpetual audits and closer scrutiny in general. IT systems will deal with many processes that were manual or semi-automated in 2015, leaving stretched tax teams with more time and resources to focus on higher value activities.

³ SAF-T (Standard Audit File for Tax) is an OECD standard for the electronic exchange of accounting data from organisations to a national tax authority or external auditors. The standard is used by some European countries to file tax returns electronically.

Tuesday

Transparency: firms leave no stone unturned



From: Ayo Okonjo, Head of Private Equity, Investar Asset Management

To: Charlene Ho, Head of Tax, Investar Asset Management

Date: Tuesday 17 March 2020, 08:30

Subject: Questions from Asian tax authorities

Hi Charlene. A few Asian tax authorities have asked why our Swiss private equity guys are spending so much time in Asia talking to target companies. They are aware of our presence from immigration records and are asking whether we are there for information only or to do deals. How should we react?

Regards

Ayo.

From: Charlene Ho

To: Ayo Okonjo

Date: Tuesday March 17 2020, 16:45

Subject: Questions from Asian tax authorities

Hi Ayo. It is essential to identify what your guys are actually doing there. Too much presence can trigger a local tax presence or permanent establishment. And, that could mean that Investar (and perhaps our PE Funds) is already in breach of its tax filing obligations. Please ask your teams to check all their entries in Travel Tracker and send me the records on who was where, when, how long and for what purpose.

Regards

Charlene.

In the illiquid space, investors will continue to demand that investment professionals invest meaningfully in their own investment strategies. Remuneration, reward, carry and co-investment structures will continue to be ever more complex as investment teams are based in more and more geographies with differing employment, payroll, corporate and personal taxes. The public's perception of the relatively high levels of reward within the industry will continue to attract the attention of politicians, the media, regulators and tax authorities.

Regulators in most jurisdictions will have the technology, but not always the necessary authorisations, to make demands for information – such as the submission of travel data for key investment firm executives. To get ahead of the game and align themselves – where appropriate – with the aims of regulators, some asset managers will have decided to do this unilaterally. The exchange of information between tax authorities will be no longer limited to groupings of jurisdictions known in 2015 (e.g. the EU, G20, the US), countries will have formed clusters independently from those groupings to exchange a variety of tax-related information.

Finally, education will be able to mitigate policy mistakes. Tax authorities will often not possess the same breadth of perspective on the industry as participants, and will have come to recognise that a collaborative approach to the industry is more productive than a strict, adversarial posture. Asset managers will, in some cases, be able to assist tax authorities by frequent interaction to apprise them of new developments and complex tax dynamics. The nature of fund managers' business will afford them a global view, which may not be available to the local tax authority.

Full transparency will be a fact of life in financial markets by 2020 as global tax reporting becomes reality. Many tax authorities will attempt to collect what they see as rightfully theirs by focusing on the economic value chain of the asset manager's activities rather than solely on the physical nexus of employees of the asset manager. In 2015, within the US, economic nexus taxation has grown from ten states⁴ to be commonplace by 2020 and beyond. As a concept of taxation it has also caught on globally. So, for instance, a Singapore-based asset manager servicing a US pension fund could be subject to double taxation – from both the local US state and the Singaporean tax authority. This is despite the fact that the Singaporean manager does not have a physical presence in the US.

In 2020 and beyond, investment firms will need timely access to all their accounts in every jurisdiction and be able to make comparisons at group level. They must be able to report this in every country in which they operate in order to provide a snapshot of profits, revenues, supply chains, organisation structure and compensation. BEPS-driven country-by-country reporting and exchange of information will be used by tax authorities to put together a full picture of organisations and to share this information with each other.

In an increasingly complex world it may not be possible to operate simple, global reward and retention structures.

Fly-in, fly-out days are over

One of the main impacts of the BEPS reform agenda is a lowering of the permanent establishment threshold. The days of running a main office in a single jurisdiction are soon to be over. Operating on fly-in, fly-out in some jurisdictions won't be acceptable in 2020. Following the work of the OECD on permanent establishment threshold in 2014 and 2015, many countries treat fly-ins as if they were permanently established in the country. This means an increased level of cross-border supplies triggering more transfer pricing and VAT topics to deal with. In addition, compliance with local payroll and social security obligations adds to the global complexity of issues which the asset manager's HR and tax teams have to monitor and comply with. Individuals will also have to be mindful of their own personal tax situation and their own tax residency status.



As new cross-border distribution hubs have developed, such as the Asian passport regime, managers will increasingly be required by local regulators to have real substance and a local presence in each of their overseas territories. In order to be able to distribute widely, 'boots on the ground' will be required, including local distribution teams, local fund managers and local tax and regulatory experts. In addition, local regulators will often require regulatory capital to be held locally, leading to cross-border funding and interest deductibility issues for global asset managers.

As asset managers will need to relocate key staff to lead and operate these new local businesses, dealing with global mobility issues will be key. Having clear strategies for pay, benefits and allowances will be vital as will frequent communication between HR and the central tax function. Global reward and retention structures like carry, co-investment and Long Term Incentive Plans will need to accommodate local tax requirements to avoid double taxation risks. As employees become more mobile, these may arise, for example, on the granting and vesting of an equity award if these events take place in two different jurisdictions.

In an increasingly complex world it may not be possible to operate simple, global reward and retention structures, leading to a wide patchwork of reward structures across global businesses and thereby heightening the risk of inadvertent mistakes and errors. Reliance on local outsourced payroll providers will not be a defence when tax authorities come knocking about local payroll audits.

How will asset managers respond?

The most tangible change will be where fund managers domicile their products and their employees. Investment firms will have revisited how they operate and have established new guidelines for their staff. Many previously unregulated products will have opted for the tax certainty of regulated status.

Tax efficiency in terms of product development, distribution and rewarding key talent will be thereby redefined. As mobile employees move from jurisdiction to jurisdiction, the risk of double or even triple taxation will arise on them individually or from an employer's perspective as different countries seek to tax reward features, such as deferred bonuses, carry or share-based reward structures, under different rules. Firms will have to decide, for example, whether employees in local markets should share in a global bonus pool or whether they should structure rewards differently depending on the jurisdiction.

Many firms will have decided that a greater level of engagement with tax authorities is advantageous. While some firms would be worried that engagement would invite excessive scrutiny, others will have realised that the release of a large body of information into the public domain requires engagement in order to manage it sensitively.

Organisations will have become more PR savvy about their tax affairs. The advent of BEPS will have led to increased media scrutiny of the sector, with a spate of – not always positive – headlines about the asset management sector. Given the option of the PR agenda being driven by the organisation itself or the tax authorities, most will have preferred the former.



Wednesday

Portfolio taxation becomes a key battleground



From: Manish Agarwal, Product Development Director, Investar Asset Management

To: Charlene Ho, Head of Tax, Investar Asset Management

Date: Wednesday 18 March 2020, 12:20

Subject: New pan-Africa product

Morning Charlene. The investment and PR teams are ready to fly out and get the Investar Africa Infrastructure Bond Fund off the ground. Any last tax thoughts before they go?

Regards

Manish.

From: Charlene Ho, Head of Tax, Investar Asset Management

To: Manish Agarwal, Product Development Director, Investar Asset Management

Date: Wednesday 18 March 2020, 19:50

Subject: New pan-Africa product

Have you thought about the transaction charges Manish? For a start, with a French bank structuring the bonds, FTT will apply, so we need to factor that into our target return projections in the prospectus and pitch-books. And withholding taxes are now applicable to many transactions originating in Africa.

I propose that we also check carefully responsibilities for monitoring withholding and capital gains tax charges, including the filing of reclaims where possible in our (sub-) custody arrangements. We had recent surprises in South America. Overall, the sub-custodian we use over there renders a great service – but we missed including an obligation for them to manage our withholding tax monitoring in the SLA. Result: 3m of tax reclaim opportunities have been lost.

Regards

Charlene.

In the years between 2015 and 2020, as the BEPS agenda impacts hybrid structures, interest deductibility and tax treaty access, there will be increased demand from investors to facilitate the understanding of the impact of tax on underlying portfolio returns.

At one time, investors, service providers and fund ratings companies largely ignored the impact of tax on performance and management fees. Capital gains tax, for instance, was not on the radar of many investors in 2015. Not because the rates were insignificant – they tended to converge at around 10% – but because the rates were opaque in some markets and the responsibility for reporting them was unclear.

By the early 2020s, performance evaluation and attribution will focus predominantly on post-tax yields. Prospective investors will ask about tax disclosures and after-tax returns even before considering their individual tax charge – before they consider investing in a fund.

Investors will expect the asset manager to indicate tax charges from their investments on their individual level. Furthermore, asset managers will disclose the tax charge on investor level for most relevant investor types in the respective region of distribution, such as individual investors, corporate investors, family offices, pension funds, insurance companies, etc.

The actual charge on investor level will depend on many factors specific to the asset manager, as

managers will have a developed methodology. This will be disclosed to investors and constantly updated as a response to changes in the tax legislation.

In the years between 2015 and 2020, as the BEPS agenda impacts hybrid structures, interest deductibility and tax treaty access, there will be increased demand from investors to facilitate the understanding of the impact of tax on underlying portfolio returns. This will dovetail with a demand to report after-tax returns so investors can compare funds across investment firms and across geographies.

A new raft of transaction taxes

Why will investors' expectations change? One of the major themes in the years to 2020 will be the tax authorities' desire to align the taxation of income from investments with increased taxes on businesses and ordinary taxpayers. As a result, funds in 2020 will have to contend with both higher withholding taxes and higher capital gains taxes.

Local tax authorities will be aware that most investment vehicles are domiciled abroad, and will increasingly seek to take a slice of the asset management cake from transactions. So there will be a proliferation of local transaction taxes that will be led by increased withholding taxes on dividends and capital gains proceeds. The reverse is also true: in some cases transaction taxes will be applied to local investment vehicles buying assets abroad.

Alternative strategies will be particularly impacted. Some tax authorities in 2020 and beyond will treat a number of alternative investment fund strategies as financial trading (commercial activity) rather than as (passive) investment activity. This will trigger the taxation of fund investors and the fund itself.

Impact of MSCI rebalancing

The MSCI World Index will be significantly re-balanced by 2020 to reflect the increase of GDP in China and other emerging countries. As a result, index trackers will have increased their weightings to emerging market assets, which means they will incur significant transaction and capital gains taxes, particularly where there is no double tax treaty.



As product solutions proliferate, asset managers will get used to dealing with a wider range of different fund regimes and legal structures. Often, tax-transparent funds will be more tax efficient, but will give rise to complex tax questions at the same time.

The proliferation of portfolio-level taxation will have fundamentally changed the way that asset allocation and portfolio construction are performed. Portfolios in 2020 and beyond will be frequently structured to achieve competitive post-tax yields. A number of pre- and post-tax fund ranking tables will have emerged to allow investors to compare funds. Some of these rankings will measure absolute returns, while others will provide a barometer on the certainty of tax results. However, this emphasis on after tax-performance may create fiduciary issues because not all investors will have the same tax requirements as each other or as the manager.

Due to the high impact, taxation positions will need to be assessed in real time to avoid the risk they evolve into a net asset value error.

How will asset managers respond?

Increased transaction taxes have meant a move to real-time tax clearance for portfolio-level structuring. Up to 2015, tax calculations were performed only at the end of each tax year. The implications were often assessed too late. In 2020 and beyond, in the wake of continued accounting disclosures changes which demand that businesses disclose income tax risks, they will be assessed on an upfront basis.

Every asset purchase and sale will be tax optimised. In 2015, the taxation of securities lending, for instance, penalised fund investors in some countries. Funds were less inclined to change this practice because it enhanced their reported performance through the fees that securities lending generated.

By 2020, Total Tax Ratio will become a standard alongside the Total Expense Ratio: funds will determine the actual tax leakage on portfolio level. In addition, funds will determine the individual tax leakage for some key investor types. Both figures together will become Total Tax Ratios which investors can compare across different fund offerings for target markets and also see in relation to the performance.

When launching new products, asset managers in 2020 and beyond will carry out full assessments of how to make products competitive in all channels. For this to happen, tax will need to permeate the entire organisation and tax departments will need to make it a priority to keep abreast of global developments around the world (in real-time). This may require a local presence, not only to stay ahead of local tax changes, but also to have access to and influence local tax authorities.

Cross-border transactions and taxes will have increased the need for local paying agents, tax representatives and tax agents. Services such as reclaiming withholding taxes, often bundled in 2015, will have become standalone services, commanding material fees. Funds will have also begun to purchase tax insurance more regularly – as some did at the introduction of FIN 48⁵ – to assure tax certainty. Due to the added complexity and specialisation required, as well as the significant investment in tax technology, many custodians and fund administrators will have either exited the tax reporting business completely or co-partnered with a tax firm to provide this service. Those that will have continued to provide the service will have significantly changed their delivery model and invested heavily in tax process and technology.



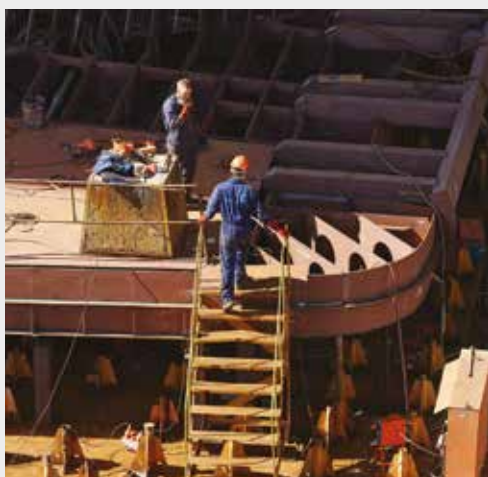
Up until 2015, tax calculations were performed only at the end of each tax year. The implications were often assessed too late.

⁵ FIN 48 requires businesses to analyse and disclose income tax risks, and applies to all entities adhering to US GAAP.

In 2015, a fund would typically be based in Luxembourg or Dublin and would be targeted at a wide range of European investors.

Build, buy or borrow

By 2020 and beyond, firms will explicitly choose a growth strategy in order to remain competitive. To develop the chosen business model, firms will pursue one or more of three growth strategies: building, buying or borrowing. Builders will grow by building out their internal organisations, leveraging and developing their existing capabilities and investment talent. Buyers will expand their capabilities across asset classes and strategies by acquiring talent, track record and scale overnight. Borrowers will partner with other institutions, including asset managers, wealth managers, private banks and fund-of-funds, to expand their investment capabilities and distribution channels. These relationships include distribution arrangements, joint ventures and sub-advised relationships.⁶



Tailor-made funds with local focus

The sales process will be impacted as much as asset allocation by the shift to after-tax performance reporting. Investors will put much more pressure on asset managers to optimise the tax costs and risks of funds, so after-tax yield becomes a key sales argument. This will impact the focus of investors' due diligence on funds.

Investors will have gravitated towards managers who offer differentiated products reflecting investor-specific tax profiles and who can fulfil the requirements of relevant tax regimes. In particular managed accounts or funds of one will have continued to be demanded by pension funds, to ensure that their preferential double tax treaty access is not tainted by other investors; and by Sovereign wealth funds, which do not want any reputational attachment to funds that might be found to have tax issues.

Tax-tailored products will exist for different clients and geographies. In 2015, a fund would typically be based in Luxembourg or Dublin and would be targeted at a wide range of European investors. This would be deemed logical in order for firms to take advantage of harmonisation measures and consolidate their fund ranges. However, by the 2020s the increased focus on tax and bespoke structures will have reversed the process of standardised comingled products, and will have led to more customised products.

Although in the period up to 2015 asset managers sought to aggregate investors into fewer fund products in order to manage costs, in the period to 2020 more funds and specific products will have subsequently been required to serve the tax and regulatory needs of different investor groups (institutional, private, banks, insurance companies and retail). This is particularly true in Europe where the removal of distribution-linked fees under

MiFID II will have led to an explosion of differently priced share classes. Although costs will have risen, so will after-tax yields on funds, pleasing clients and helping funds with client retention.

As managers generate greater awareness of an investor's tax position – through the onboarding process and the need to continually assess an investor's ongoing tax risk profile – they will be able to work with investors around investment product design, including philanthropic giving, planning for inheritance taxes and inter-generational wealth transfer. So for high-net-worth (HNW) and ultra high-net-worth (UNHW) investors, the boundaries between asset management, wealth management and discretionary private banking will be blurring. This process will be supported by the widespread ban of inducements, which will have encouraged asset managers to build out their capability to deal directly with the end-customer in the retail space. By 2020 and beyond, integrated businesses combining asset management, wealth management and private banking skills will be able to provide a full tax advisory service to clients. These businesses will have been built by building, buying or borrowing (see box, opposite).

Asset managers, along with the rest of the financial services world, will have to demonstrate their social utility. Asset management firms, as is the case for all corporate citizens, will be expected to pay their fair share towards the taxes of the countries in which they operate.

Furthermore, by 2020 and beyond, asset managers and industry bodies will be regularly engaging with politicians, the public and the media to explain the social usefulness of an industry which supports savings and investment and which will have helped to create the investment products for recovery and growth: from the financing of small- and medium-sized enterprises (SMEs) in Europe to the building of vital infrastructure in Africa.

⁶ Source: Alternative Asset Management 2020 – Fast Forward to Centre Stage. PwC June 2015.

Thursday

Tax branding is at the heart of marketing and reputation



From: Sue Plimmer, Head of Media Relations, Investar Asset Management

To: All Staff

Date: Thursday 19 March 2020, 09:00

Subject: Tax branding

Dear All.

Please note that our media pack released today highlights the tax paid by Investar at corporate level and by all our local funds and offices. As you know, this information is important not just for regulatory purposes, but also for assuring clients of our commitment to paying our fair share, to global tax compliance and to their tax needs. It's a vital part of our distribution strategy, so please feel free to discuss our tax-aware and tax-transparent policies with clients.

Regards

Sue.

Tax uncertainty will be minimised through robust controls, strong governance, and risk management processes. Accounting standards requiring provision for uncertain tax positions and continued investor pressure to avoid surprises will have led to new more robust tax governance functions at asset management firms. As a result, tax will be viewed as an operational business risk in the same way that valuation and cyber came to be viewed as operational business risks years before.

The asset management firm itself is not the sole focus of scrutiny. Founders, senior executives and the highest-paid portfolio managers and analysts will also be the subject of increased tax authority and media attention, with relative pay in the sector being an area of particular

interest. In Europe, by 2020, regulation will have been in force for some time, which will require all European asset managers to defer a significant part of bonuses into equity and to cap bonus levels. This will necessitate enhanced reporting and functionality within tax teams.

Even in Asia, where pay disparity is not as high and political and social pressure on firms is less pronounced, fees, compensation and 'tax branding' will be a live issue in 2020 and beyond. Alignment with tax authorities will be important for both asset management firms and key staff, and should be a key consideration before a product launch. Reward and tax will be high up the political agenda for firms, just as they were for banks and high-profile industrial and retail companies in 2015.



By 2020 and beyond, asset managers will sponsor education programmes to ensure that future generations understand the range of investment products open to them, understand risk and the need for savings in a world where longevity continues to increase.

PR gets involved with tax

Asset managers and their clients, keen to avoid being tainted by association with inefficient and potentially inaccurate tax compliance, will have become highly proactive on the issue. Asset management PR efforts in 2020 and beyond will focus not just on fund performance, but also on tax and compliance, with detailed statements released into the public domain on tax policies, the amount of tax paid and where it is paid.



Alignment with tax authorities will be important for both asset management firms and key staff, and should be a key consideration before a product launch.

How will asset managers respond?

Control reports and internal audits of the tax function will be carried out by many asset managers in 2020. For the first time, auditors will review and place their stamp of approval on tax functions. Larger investors will begin to rely on these audits and make them part of their overall due diligence on asset managers. Then service alpha, which adds value to the performance of a fund through the quality of the infrastructure, will be a factor in investors' selection of an investment manager.

The concept of nominee accounts in investor registers of funds will be under considerable pressure and many asset managers reject nominee accounts, despite the resulting loss of business. Consequently, the number of accounts held by investors directly with asset managers will have dramatically increased.

As tax authorities and regulators increasingly look to outsource responsibility for policing tax and regulatory systems, there will be no way for funds to accept investor capital without assurance that it is not sourced from the proceeds of tax evasion. This will involve a massive change of responsibility for asset management onboarding teams. If clients cannot prove they are not compliant with their own tax administration, asset managers will refuse to onboard them. This will have completely changed the skillsets required within sales and marketing teams. Tax professionals will be embedded within local sales and marketing teams to help address tax onboarding issues, a key component of investor suitability assessments.

Asset managers will sponsor education programmes to ensure that future generations understand the range of investment products open to them, understand risk and the need for savings in a world where longevity continues to increase.

As part of demonstrating the social utility of the asset management

industry, some managers will go beyond the new country-by-country report obligations and will instead report on the 'total tax' contribution which they and the funds they manage contribute to the local economies in which they operate. For the manager, this will cover corporation tax, VAT, employer and employee-related payroll and social taxes, plus miscellaneous taxes such as stamp duty, air travel duty and local taxes.

Indirect alpha created by the tax team

By 2020 and beyond, technology will have created the ability to differentiate between the alpha created by the portfolio manager and the alpha created – indirectly – by the capability of the tax team to optimise tax leakage and proactively identify and minimise tax risk. Funds that demonstrate tax efficiency at the fund and investor level relative to their peers will have a distinct advantage when fundraising in a highly competitive environment.

Rankings of tax infrastructure will still be immature, but will be gaining traction among investors and fund rating agencies. Some rankings will award grades so investors can make direct comparisons, while others will be straightforward seals of approval, showing that a firm has attained a certain level of quality. These rankings and seals of approval in 2020 will be widely used on investment firms' websites and in their company-wide and fund literature.

Asset management enters the tech age – the tax function must follow

The smart use of technology will be instrumental for any asset manager's tax function. We have already illustrated the high growth in the number of tax items to be monitored

and the requirement to ensure monitoring is in real time. Meeting the challenges will be impossible without a smart IT landscape.

There will be a sea-change in how asset managers view the tax function and the associated costs. While the investment floodgates will not have opened in an unfettered way, there will be recognition of the importance of a robust tax function, the impact tax issues can have on the brand and the historic underinvestment in tax and tax technology, especially in the area of reporting to investors. There will be a greater emphasis on the better use of technology to increase efficiency, tighten controls around compliance procedures, avoid regulatory penalties and retain documents. Tax technology will have increased the quality, timeliness, efficiency and transparency of tax reporting. In addition, the better use of information and technology will have become a key value-add for many asset managers and will be driving how they serve their investors.

Technology in 2020 will be critical for the delivery of operational efficiency and for minimising the costs of the ever-increasing tax compliance burden with asset managers. Technology for tax will enable investment firms to make timely tax-informed investment decisions and to provide investors with the transparency and reporting that they need.

Real-time clearance of tax positions with tax authorities will become an essential risk management measure, especially for illiquid asset classes, where sophisticated investors routinely undertake due diligence on the tax portfolio modelling capabilities of the investment teams at asset managers.

Friday

Tax technology is key to performance and client satisfaction



From: Angus Moreland, CEO, Investar Asset Management

To: Chris Brown, CIO, Investar Asset Management

Date: Friday 20 March 2020, 13:20

Subject: Fund Performance

Hi Chris. In your report to me this month, you said performance across our fund range was up.

This is not reflected in the latest fund ratings. What's going on?

Regards

Angus.

From: Chris Brown

To: Angus Moreland

Date: Friday 20 March 2020, 14:00

Subject: Fund Performance

Angus, our fall in the ratings reflects the new ratings criteria which incorporate the alpha created by our fund managers, our funds' tax leakage and an assessment of our ability to identify and address future tax exposures through our technology. The ratings guys just don't think our tax technology is up to scratch to successfully manage and report on tax risks and leakage compared to our competitors.

Regards

Chris.

Growth of flexible modelling tools

The pace of BEPS-related changes in the period from 2015 to 2020 will mean that expected tax outcomes at the investment stage will often not be the same as that realised over the life of holding the investment. Private equity, real estate, infrastructure and debt fund managers will have had to develop tax-flexible portfolio modelling tools to be able to manage and assess potential tax impacts of new Controlled Foreign Corporation (CFC), anti-hybrid, anti-avoidance regimes, transfer pricing and interest deductibility rules. Being seen to be on top of the changing tax impact for illiquid portfolios will be key for alternative asset managers.





Data security will be high on the agenda of tax functions due to concerns over confidential information being inadvertently released or shared publicly.

How will asset managers respond?

By 2020 and beyond, fund organisations have taken steps to upgrade their technology, with solutions for compliance a given, and new value coming from strategic planning, data analytics and investor reporting. The historically heavy reliance on spreadsheets will no longer be acceptable. Organisations will decide to either build database technology or buy into an outsourced vendor solution. This shift will have forced many fund administrators to maintain their focus on books and record calculations and to either exit the tax administration business, or team up with a tax firm. Conversely, to support this demand, a number of advisers to the industry will make material investments in technology in order to meet compliance and reporting practices.

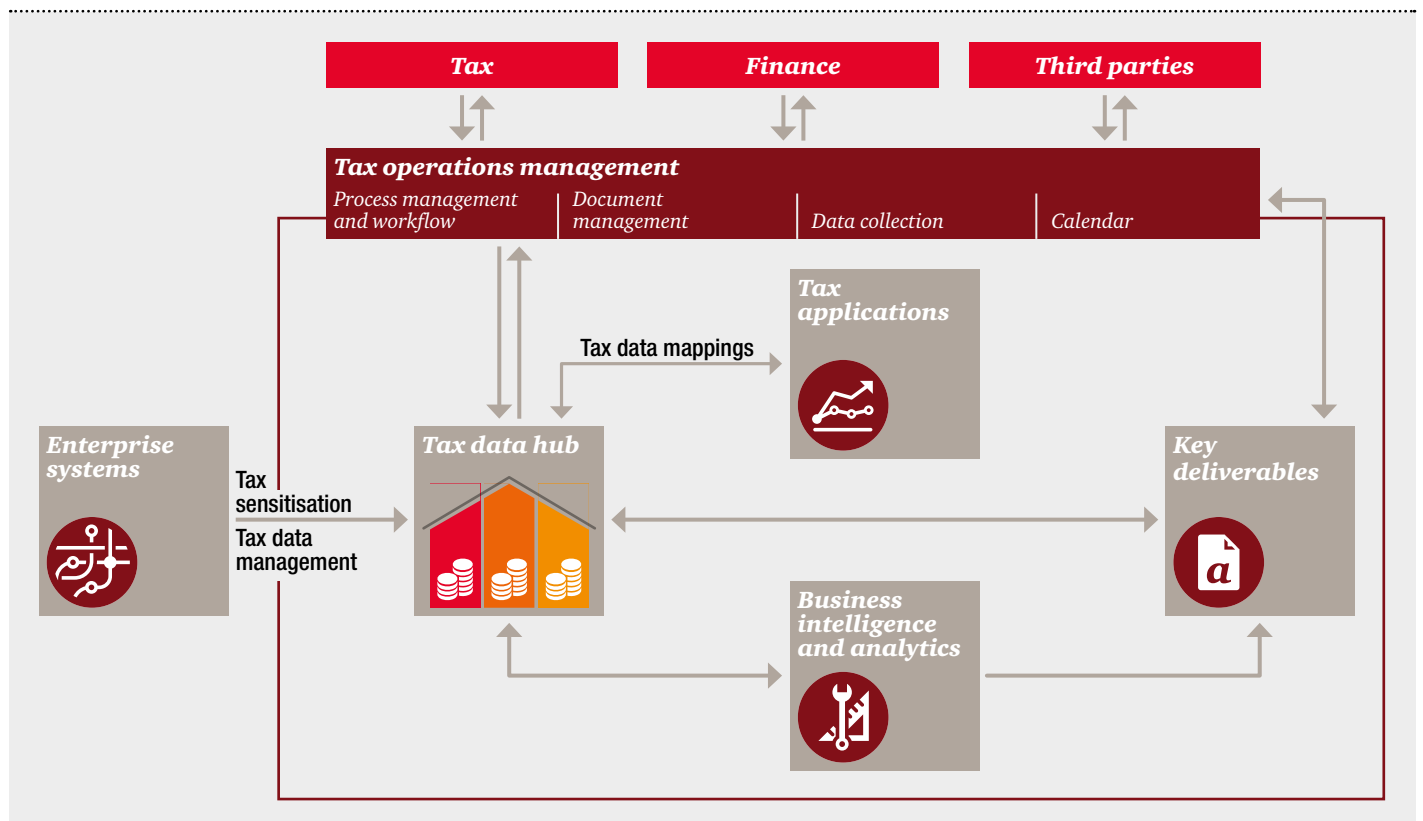
In addition, fund tax functions will receive more information in a tax-ready format from either their enterprise-wide financial

systems or their tax data hub. Using this information, most global tax preparatory compliance and reporting activities, including data collection and reconciliations, will be performed within the company’s shared service centre or co-sourced with a third party. As tasks and deliverables will be handled by geographically distributed resources, tax functions will use real-time collaboration tools to automate their workflow, document management, calendaring and internal controls. Data security will be high on the agenda of tax functions due to concerns over confidential information being inadvertently released or shared publicly.

Tax-enabled databases

The overwhelming trend will be to move the tax process to a technology-enabled environment that connects existing technologies, including investor, legal entity management and financial systems, to tax-sensitised databases which are connected to a central data hub (see Figure 2).

Figure 2: The tax data hub: where technology and tax intersect



These databases will automate key calculations, provide structure to underlying data and return the final results back to the data hub where it is stored alongside the source data. What this ultimately means is that investors will get more information faster with less risk of the inconsistency typical associated with human intervention. Meanwhile, tax professionals will have more time and data available from the data hub to focus on strategic tax deliverables that could positively impact funds' after-tax performance and the performance of the investment firm overall.

Advanced analytics tools

With central access to data, managers will use advanced analytics tools to provide real-time access to transaction-level data on an after tax-basis to perform investor-centric activities such as scenario planning, trend analyses and tax efficiency calculations. Key stakeholders within and outside of tax will demand and have instant access to granular tax data in order to focus on activities such as tax-advantageous deal structuring and tax-optimised trading operations. This granular data will also support increased reporting demands.

Embedded tax costs within complex investment structures will become a key due diligence point on illiquid asset classes. The ability to real-time monitor and evidence potential best and worst case scenarios will become a factor impacting the internal rate of return on such funds.

Technology tools will allow fund managers and investors to monitor tax services at their service providers in real time. Up-to-the-minute insight into workflow and deliverable tracking will change how service providers and clients interact. Clients will no longer

have to raise queries by phone or email, but will be provided with a dashboard to follow, for example, the progress of withholding tax reclamation.

Fund managers, via their service providers, will be able to perform scenario testing in real time to assess the tax sensitivity of buying and selling assets for a particular investor. This automation will hugely reduce the pressure on asset managers and provide an additional value-add service to clients, who will no longer have to wait for a manual response to queries. This kind of tax impact modelling will provide a critical differentiator for those asset managers who provide an integrated asset, wealth and discretionary private banking service to clients.

Risks to the organisation will be mitigated through the use of document retention and collaboration tools. The use of real-time collaboration and document storage tools will allow for version control and provide access both internally and externally. Documents will be tagged with meta-data to allow instantaneous searches. File structures will be abandoned.

The use of process and workflow tools will put proper internal controls around processes that have historically been known only to the user. Controls will enable the organisation to better institute new policies and develop stronger relationships with regulatory agencies, thereby strengthening marketability to investors.



The tax function in 2020 and beyond

Sunday



From: Charlene Ho, Head of Tax, Investar Asset Management

To: Angus Moreland, CEO, Investar Asset Management

Date: Sunday 22 March 2020 12:10

Subject: Annual report

Angus, I'm presenting the tax annual report to the Board tomorrow morning. It outlines what I see as the ideal tax function for today's environment. We are not far from it!

Please find attached the key points of my presentation.

Regards

Charlene.



Members of the Board.

The needs and role of the tax function today are vastly different compared with 2015. The transformation over the last five years has been due to a combination of external pressures and innovative uses of technology, data and human resources. The pressures from governments, investors, regulators and the public mean that 'business as usual' is long gone. The tax function has shifted from a primarily labour-intensive reporting and compliance function to a key enabler of our company's strategy. Tax risks can impact the firm's brand and governments, investors, and the public will assess the quality of our tax infrastructure as an alpha characteristic, which impacts performance on a risk-adjusted basis.

To respond to the challenges, Investar's tax function focuses on the key areas below:



Legislative/Regulatory

- Global tax information reporting requirements such as BEPS and similar transparency initiatives have grown exponentially and now have a material impact on the operations. This has meant wholesale budget re-allocation within the tax function.
- The tax function is now exposed directly to regulators, which demands transparency regarding global taxation and to public stakeholders. This requires us in the tax function to communicate clearly and thoughtfully about our corporate contribution to the communities in which we invest and do business.
- Information sharing is commonplace among taxing jurisdictions, and taxing authorities have the capability to mine data and conduct global audits, resulting in increased disputes. This means we deal with many more enquiries from authorities. The focus on reviewing data and ensuring data quality before it is made available to the authorities has become considerably more intense compared with 2015.



Risk & Governance

- Many jurisdictions legislatively require the adoption of a tax control framework which follows guidelines similar to Sarbanes-Oxley and COSO (Committee of Sponsoring Organizations of the Treadway Commission). The onus on our tax function has been to implement these frameworks and ensure they respect local rules and guidelines.
- Enhanced stakeholder scrutiny and reputational risk have forced us as a company to continuously re-evaluate our tax decisions. These decisions are routinely supported by recommendations by the tax function. In a legislative environment which leaves more questions open than in the past, this means that the tax function is involved in many more 'calls' than in 2015.
- Our strategic focus on jurisdictional reporting and documentation of business activities, including transfer pricing, has been critical to managing the increased tax controversy resulting from transparency initiatives.



Data

- In the tax function, we now receive all information in a tax-ready format via our dedicated tax data hub. We have developed this internally, but across the industry hubs are also licensed from a third-party vendor, or accessed through advisers as part of co-sourcing arrangements.
- Data security is high on our agenda and we have devoted considerable resources to it, aware of the potential damage to our reputation in the case of confidential information being inadvertently released or shared publicly.



Technology

- We use enterprise-wide financial systems to prepare tax calculations (such as income tax accounting and indirect taxes). This has replaced spreadsheets and other traditional tax technology solutions used back in 2015.
- We now rely widely on professional data analysis tools to assist in decision-making in areas such as detection of risk, opportunity identification, projections and scenario planning, and overall business support.



Process

- Most global tax preparatory compliance and reporting activities, including data collection and reconciliations, are now performed within our shared service centre. Other companies achieve this through co-sourcing with a third party, which is equally viable.
- Our company views tax as an operational risk and we carry out regular risk management analysis.
- As you know, we provide regular reporting of key tax risks to the CFO, the COO and you, the members of the Board.
- We use real-time collaboration tools to automate workflow, document management, calendaring and internal controls.



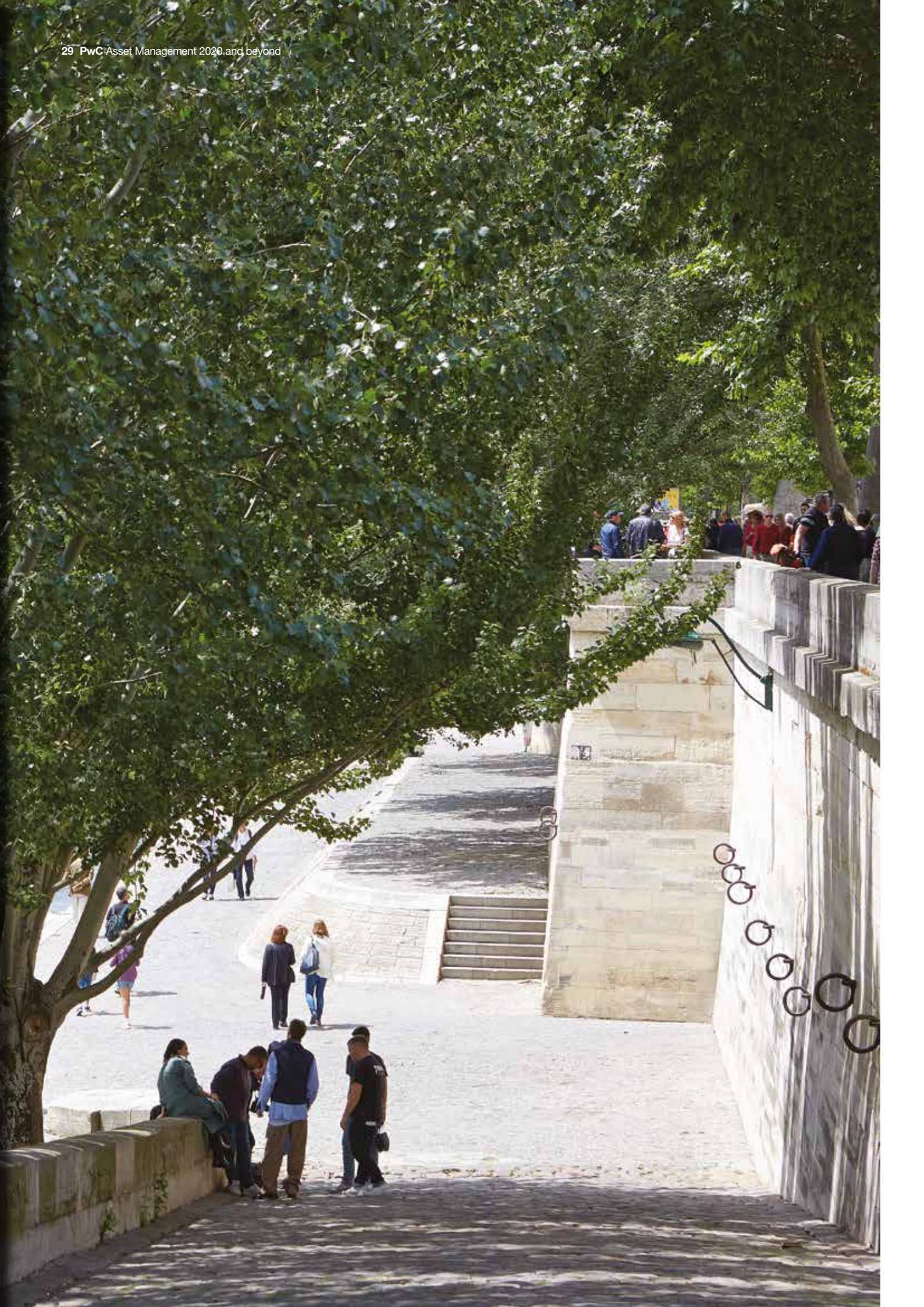
People

- Our tax professionals as a group are highly proficient in data analysis, statistics and technology, as well as process improvement and change management.
- We employ dedicated tax IT, data and project management specialists who develop, champion and execute our tax technology and transformation strategies.

In short, the role of the tax function has emphatically changed. Its priority now is to provide assurance that we, our funds and our investors are paying the right amount of tax, to the right tax authorities, at the right time. This is key to our financial health and to our reputation in the marketplace.

I hope you will agree and I look forward to your thoughts.

Charlene Ho.



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