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A legal update from Dechert's Tax Group

Tax Changes for Investment Managers and Offshore Funds

Pre-Budget Report

The United Kingdom Treasury released to Parliament on 9 October its 2007 Pre-Budget Report and Comprehensive Spending Review ("Pre-Budget Report"). We have set out below some important tax issues arising from the Pre-Budget Report that are of particular significance to offshore funds and investment managers.

Offshore Funds

The Government has issued a discussion paper that proposes to change existing tax rules applicable to offshore funds and their investors.

Current rules seek to tax certain gains of investors in offshore funds as income. However, provided the offshore fund qualifies as a distributing fund such gains remain subject to tax as capital gains. The proposed new rules will broadly retain this approach for investors but will change the rules that determine the type of fund that can confer capital gains treatment on its investors. Given that from 6 April 2008 capital gains tax will be imposed at a flat rate of 18% for individuals (see below), this issue will assume greater importance for investors.

The discussion document envisages a new taxation regime being introduced for offshore funds when the Finance Bill 2008 receives Royal Assent (Summer 2008). Some of the key proposals are as follows:

- A new definition of "offshore fund" is proposed for tax purposes. The new definition would be based on certain key characteristics rather than the current definitions, which are based on definitions in the Financial Services and Markets Act 2000. In summary, it is proposed that an offshore fund for the purposes of the new legislation will be any non-UK vehicle where investors pool their money to invest collectively in various assets where those assets are not managed by the investors themselves. However, the new definition would only apply to offshore funds that provide investors with a return substantially equivalent to the net asset value of its share in the fund. Further, it would exclude funds that are tax transparent for income purposes, such as most offshore property unit trusts. This would also exclude many funds established as partnerships that would be of relevance to many hedge funds.
- Distributing fund status would be replaced by reporting fund status. This would differ from distributing fund status in the following ways:
  - The requirement to distribute 85% of income would be replaced with a need to report 100% of the fund's income. This means that there would no longer be a need to physically distribute income but rather there may be deemed distributions or a combination of physical and deemed distributions. Deemed distributions should assist those funds which seek to accumulate income. A UK investor in a reporting fund will be taxable on its share of income in the reporting fund whether or not it is actually distributed.

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- The rule that a distributing fund may not invest more than 5% of its assets in other offshore funds would be abolished. Instead, funds investing in other offshore funds would need to take into account reported income of those funds for the purposes of its own reporting requirements. If the fund is a non-reporting fund, the income would be based on the increase in the fair value of the fund over the period. This would be a useful simplification measure but may lead to unpredictable amounts of reportable income flowing up into reporting funds from investments in non-reporting funds (which may include many hedge funds).

- It is suggested that a new calculation of reportable income based on IAS/GAAP serve as an alternative to the current UK equivalent profits (UKEP) calculation. The intention of this proposal is to reduce the administrative burden of calculating UKEP. However, it might also provide an opportunity for more hedge funds to become reporting funds as compared to those previously able to obtain distributing status, thereby enabling their investors to obtain the benefit of capital gains treatment. This would be on the basis that an appropriate accounting-based test of income could remove the concern about trading activity profits constituting income. However, it is not yet clear whether an accounting-based test will provide a workable solution.

- An advance clearance procedure would be established so that a reporting fund would not need to seek certification in respect of past accounting periods, as is currently the case. This would produce greater certainty for investors on fund launches.

The Investment Management Exemption

Offshore funds and UK-based investment managers can become subject to UK taxation on profits generated by the fund if the conditions associated with the "Investment Management Exemption" (IME) cannot be met. This is particularly so with hedge funds as they are more likely to be carrying on a trading activity rather than an investment activity, for UK tax purposes. One of the conditions of the IME is that it only applies to "investment transactions" and although the scope of such transactions has been extended recently, HM Revenue & Customs (HMRC) will align the definition more closely with the definition used for regulatory purposes. This will include a wider range of transactions within the definition, such as transactions in renewable energy related products and other new structured products.

In addition, HMRC previously took the view that if an offshore fund carried on a single transaction through its UK investment manager that was not an investment transaction then that could give rise to UK taxation in respect of all transactions carried on by the investment manager in the UK on behalf of the fund. HMRC now proposes to introduce a more proportionate tax consequence should such an eventuality arise. This is a sensible and welcome change that the industry has been pushing for some time.

Capital Gains Tax

From 8 April 2008, there will be a single tax rate of 18% applicable to capital gains of individuals and trusts. This will almost double the rate of tax for a hedge fund manager on the sale of his business |and therefore consideration should be given to advancing sales prior to 6 April 2008 where possible. Conversely, this will reduce the tax rate relevant to sales of interests in distributing funds, making this a more significant issue for investment managers and investors (see above).

Non-Domiciled Individuals and Residence

With effect from 6 April 2008 new legislation will introduce an additional tax charge for non-domiciled individuals using the remittance basis of taxation (so that after being resident in the UK for 7 years, a non-domiciled individual may only use the remittance basis of taxation if they pay an additional of £30,000 per year). All previous years of UK residence will count from that day. In addition, UK resident but non-domiciled individuals using the remittance basis of taxation will cease to be automatically entitled to personal tax allowances. However, the restriction of the remittance basis with respect to investment income arising in the Republic of Ireland will be removed, which may benefit UK investors in certain Irish funds. There has also been an important change to the residence rules so that

days spent travelling to and from the UK will count as days spent in the UK. This is contrary to past practice, which did not count such days and will accordingly increase the likelihood of individuals being treated as UK resident.

Financial Derivatives

HMRC has confirmed that the use of financial derivatives is not of itself indicative of trading.

Taking short positions is no more or less likely to constitute trading than taking long positions. Although this clarification is helpful, it does not, of itself, clarify whether a hedge funds activity is or is not a trading activity for UK tax purposes.

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