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A legal update from Dechert's Tax Group

The Investment Management Exemption – New Statement of Practice Published

On 20 July 2007, HMRC issued its long-awaited revised Statement of Practice 1/01 ("SP") on the "Treatment of Investment Managers and their Overseas Clients". The SP is of critical importance in helping to determine whether funds and other clients of UK investment managers (and investment managers themselves) will be liable for tax in relation to trades carried out in the UK through the agency of the investment manager as it provides guidance on how HMRC interprets the law on this issue in practice.

Investment funds and other clients not resident in the UK for tax purposes can be liable for UK tax on trading profits where the trade is carried on in the UK through an agent, such as an investment manager. However, special rules (the so called "Investment Management Exemption" (IME)) were devised over a decade ago to provide protection from such a charge where the agent is an investment manager. In order to take advantage of these rules, the following conditions must be met:

- The manager must act in the ordinary course of its business.
- The manager must act in an independent capacity (the independence test).
- The manager and connected parties must not have an entitlement to more than 20% of fund profits (the 20% test).
- The manager must receive not less than a customary rate of remuneration for its services (the customary rate test).
- The fund/client must not otherwise trade through the manager in the UK.
- The exemption only applies to investment transactions.

HMRC has consulted with the investment management industry and other interested parties for over a year on revisions to the 2001 SP. Their initial proposed changes caused significant alarm within the industry, mainly due to the proposal to remove some key "safe harbours" relating to the independence test, and because of their suggestion that a single failure to comply with the IME might lead to all profits of the fund conducted through the UK manager being liable to UK tax, even in relation to other compliant trades.

However, it is clear that HMRC has listened very carefully to the views put forward by the industry during the consultation exercise and the new SP has largely assuaged those concerns. On the whole the revised SP now offers a clear and sensible interpretation of the various tests and provides guidance on other related matters.

The key points which should be noted from the revised SP are the following:

1. The IME only applies in respect of defined "investment transactions" and the SP now provides greater clarity on various common investment strategies. Whilst direct investment in physical commodities and land remains excluded, futures and options in commodities (provided no physical delivery occurs) are included as are futures and options involving certain indices of land. Credit default swaps, whether settled physically or by cash are also included. It should be remembered that carbon emission credits have now been included through recent legislation. There is also more clarification regarding lending arrangements. In particular, any fees paid in connection with the commitment, placement or documentation of funds lent at interest will be regarded as an investment transaction, although fees for

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taking a lead in arranging or originating a loan or managing such a loan will not be included. However, provided the latter are taxed in the UK, either in the hands of the offshore person or in the hands of a UK investment manager, then the IME will not be breached. Interestingly, the SP also provides that if the investment manager receives taxable syndication fees, which are matched by a reduction in the fees payable to it by the offshore person, then the IME will not be jeopardised;

2. A minor or inadvertent non-qualifying transaction will not generally cause the IME to be failed, provided the profit of such a transaction is charged to tax in the UK;

3. There are some useful sections on HMRC's approach to the question of whether a transaction is trading or capital in nature. In particular, HMRC state that neither going short nor taking synthetic positions using derivatives are in themselves indicative of trading;

4. Various "safe harbours" have been retained in respect of the independence test. A fund will be considered independent if it is "widely held" (broadly no majority interest in the fund is held by five or fewer persons *or* no single person holds more than 20% of the fund) or if the fund is being actively marketed with the intention that it become widely held. The fund will, however, have 18 months from inception to meet the widely held test. If the widely held safe harbours are not met then provided the services provided to the fund in question do not represent more than 70% of the investment manager's business, the independence test will be met. An investment manager will have 18 months from the start of its business to ensure that its services to the particular non-resident do not represent more than 70% of its business. The test will still be met if it can demonstrate that a failure to bring it below 70% was for reasons outside its control, having taken all reasonable steps to do so. One safe harbour test that has been removed is that of having the fund quoted on a recognised stock exchange. Where reliance has, therefore, been placed upon that safe harbour, a fund and its investment manager have until 31 December 2009 to ensure that one of the other safe harbours is met, or to be confident that independence can otherwise be demonstrated to HMRC.

5. In relation to the 20% profits test, the revised SP makes clear that profit allocations are included as fees (recognising that these arrangements are often used in the case of US funds/US managed funds) and that deferred fees are taxable when earned rather than when paid. There is also specific reference made to certain master-feeder structures in the context of the 20% test and the point is also made that where securities or interests in the fund have been provided to the manager as a reward for services, the return generated on those will count towards the 20% test;

6. The revised SP confirms that the customary rate test will be determined by applying transfer pricing principles and will be determined, taking into account all circumstances, on the basis of the net fees earned by the UK investment manager. There is specific acknowledgement that the use of rebated, reduced or zero fee arrangements made between the fund and/or the manager and unconnected investors will not generally jeopardise the customary rate test. If the manager or a partner, director or employee of the manager receives securities in the fund for services provided by the manager then provided such securities are charged to UK tax then the customary rate test is capable of being met.

7. The SP also provides that where a special management share class is created in the fund bearing a reduced or zero fee then that in itself will not generally cause the arm's length principle to be breached, although there may be income tax consequences for the individuals concerned.

8. The SP does stress the importance of appropriate documentation and evidence being acquired and retained to support the arm's length nature of the fee arrangements put in place. Provided such documentation is in place, HMRC have stated that even if the customary fee test is subsequently shown not to have been met, then although a transfer pricing adjustment would need to be agreed with the investment manager, HMRC would not deny the IME on the basis that the customary rate test had been failed.

The revised SP has immediate effect save for those persons who need to make changes in order to become compliant with the revised interpretation. In those cases, the 2001 SP may be applied until 31 December 2009.

In the past, HMRC has not had a practice of raising assessments on investment managers and their clients for breaching the IME. The impression given by the revised SP is that this practice will continue provided serious avoidance or evasion is not involved and reasonable efforts are being made to comply with the revised rules. However, the requirement to keep proper records, in accordance with transfer pricing guidelines, should not be underestimated, and every effort should be taken to ensure full compliance with the IME conditions.

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