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March 2008

A legal update from Dechert's Tax Group

Budget 2008 – Tax Changes for Investment Managers and Offshore Funds

On 12 March the United Kingdom Treasury released to Parliament its Budget 2008 report. We have set out below some important tax issues arising from the Budget that are of particular significance to offshore funds, investment managers and the financial services industry generally.

Reporting Fund Regime for Offshore Funds

The Budget announcements follow a period of consultation in respect of proposed changes to the 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 during the period of ownership, such gains remain subject to tax as capital gains. In its October 2007 discussion paper, the Government proposed the introduction of a new tax regime to change the rules that determine the type of fund that can confer capital gains treatment on its investors. This is particularly relevant now that the capital gains tax rate for individuals will drop to 18% from 6 April 2008. The Budget confirms that legislation will be introduced in 2008 to enable the proposed changes. It is not yet known when the new regime will commence.

Some of the key proposals are as follows:

- Distributing fund status will be replaced by reporting fund status. The requirement to distribute 85% of income will be replaced with the need to report 100% of a fund's income. This means there will 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.

- The rule that a distributing fund may not invest more than 5% of its assets in other offshore funds will be abolished.

- It is suggested that a new calculation of reportable income based on IAS/GAAP will be introduced as an alternative to the existing UK equivalent profits calculation. If this is followed this should ease the administrative burden of the existing system and enable more hedge funds to qualify as reporting funds.

- It is anticipated that minor failures to keep to the conditions will not result, as at present, in a fund being removed retrospectively from the more favourable regime.

The original discussion paper also proposed the introduction of a new definition of "offshore fund". The Budget stated that no such change will occur in 2008 as the Government will continue to discuss the point with industry with a view to legislating for a revised definition in 2009.

Investment Management Exemption

The Budget confirmed plans announced in the 2007 Pre-Budget Report to introduce a single list of transactions qualifying for the investment management exemption. It is intended that this will make the process for updating the list to keep pace with developments in the financial markets simpler and more responsive and will avoid the need to add qualifying investments by way of regulation, as was the case with carbon

emission credits in 2007. It is intended this change will take effect on or after the date that Finance Bill 2008 receives Royal Assent. No details were announced in the Budget of the content of the list, but it was originally proposed that the list would be aligned closely with the definition of investment transaction used for regulatory purposes.

A further change will be introduced to create a more proportionate outcome where an investment manager carries out a non-qualifying transaction on behalf of a non-resident fund. Under the existing rules such a transaction could result in the investment management exemption being failed in respect of all transactions. It is now proposed that only non-qualifying transactions will be exposed to UK tax. It is intended that this measure will take effect for the tax year 2008-09 and subsequent tax years and accounting periods ending on or after the date that Finance Bill 2008 receives Royal Assent.

Funds of Alternative Investment Funds

Draft regulations have been released which enact the proposals in the HMRC Tax Framework document released on 22 February 2008. In summary, a new tax regime is to be introduced to change the way in which UK authorised investment funds ("AIFs") investing in non-distributing offshore funds are taxed. It will also enable them to take advantage of the proposed new FSA rules for Funds of Authorised Investment Funds ("FAIFs").

Under the current regulations a gain made by an AIF on disposal of an interest in a non-distributing offshore fund is an offshore income gain and will be subject to corporation tax at the rate of 20% in the fund. In addition, UK investors in AIFs are then taxable on any capital gains arising on a disposal of their investments at the rate of 18% from 6 April 2008. Under the proposed new regulations certain funds will be able to elect for new tax treatment to make them "tax FAIFs", exempt from tax on offshore income gains. UK investors in such an elected fund would then be chargeable solely to income tax on any gain made on a disposal of their investments. This measure has the effect of transferring the burden of tax from the AIF to the investor and brings the taxation treatment in line with that for investors investing in the underlying non-distributing funds directly or in an equivalent offshore FAIF. However, the problem with this proposal is that individuals would suffer tax at a significantly higher rate when investing in an elected AIF (40%) as opposed to an unelected AIF (a combined tax rate of around 34% taking into account AIF tax at 20% and individual CGT at 18%), and this may reduce the attractiveness of such funds to investors.

Property Authorised Investment Funds

Regulations have been published to introduce a new tax regime for property authorised investment funds ("property AIFs"). Under the existing regulations an AIF pays corporation tax on rental profit or other property income, such as property income distributions from REITs or their overseas equivalents.

Under the new regulations an AIF which invests mainly in property and certain related securities will be able to elect for the property AIF regime to have effect. Where an election is made, property AIF rental profit and other property related income will be ring-fenced and will be exempt from taxation in the fund. This property income will be distributed to investors with deduction of basic rate tax. This effectively moves the burden of taxation from the fund to the investors so that basic rate taxpayers will have no further liability to tax, higher rate taxpayers will treat the income as property income and pay additional tax at the appropriate rate and UK non-tax-paying investors will be able to reclaim the tax deducted. The new regime should enable non-tax paying investors, such as pension funds, to invest in property AIFs without suffering tax.

In order to qualify for the new regime, property AIFs will have to meet certain conditions. AIFs will need to be structured as open-ended investment companies (OEICs) to qualify and at least 60% of the business must be property investment business. In addition, anti-avoidance measures are to be introduced to restrict corporate ownership to less than 10% and ensure genuine diversity of ownership.

Taxation of Personal Dividends

The Budget has continued the process of aligning the tax treatment of UK and overseas dividends by announcing that legislation will be introduced in Finance Bills 2008 and 2009 to change the tax system for individuals owning foreign shares.

Under the present rules, when dividends from UK resident companies are charged to tax, shareholders are entitled to a tax credit of one ninth of the distribution. Because tax is charged on the gross dividend received, including the tax credit, this lowers the effective rate on UK dividends to 25% for higher rate taxpayers.

Legislation introduced in Finance Bill 2008 will extend the tax credit to UK resident individuals and other EEA nationals in receipt of dividends from non-UK resident companies, provided they own less

than a 10% shareholding in the non-UK company. It had previously been announced that this treatment would only apply to the first £5,000 of overseas dividends received by an individual each year but this proposal has now been dropped.

Legislation to be introduced in Finance Bill 2009 will further extend the credit to cases where individuals own greater than a 10% shareholding in the overseas company. However, restrictions may apply if the source country does not levy a tax on corporate profits similar to UK corporation tax. This measure has raised questions over the applicability of the tax credit to dividends from tax exempt offshore funds and we must await the draft legislation for further details.

VAT on management fees

Following on from the ECJ case of *JP Morgan Claverhouse*, which held that investment trusts should be exempt from VAT on management fees, it has been announced that venture capital trusts, certain other UK closed-ended funds and overseas funds recognised under FSMA 2000 will also be exempt from VAT on management fees. This change will come in from October 2008.

Other matters

The Treasury also announced under the heading "enhancing the competitiveness of UK financial services" that it intends to work with the UK asset management industry to simplify the tax regime for collective investment funds. The areas to be looked at include discussions on a direct tax exemption for authorised investment funds, proposals to adapt the tax rules for investment trust companies to permit tax efficient investment in wider asset classes, a simplification of the rules for investors in qualified investor schemes by replacing the substantial holding (10%) rules and a possible reform of the schedule 19 SDRT regime.

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