CUMMINGS

lawyers for alternative investments

Investment Manager Exemption

Investment Manager Exemption

Introduction

The Investment Manager Exemption ("IME") allows an investment fund which is established outside of the UK to appoint a UK-based investment manager without the risk of exposing the offshore profits of the fund to UK taxation, provided certain key tests are met. The IME is one of the key components of the UK's continuing attraction for investment managers.

HMRC's policy objectives in granting the IME are twofold:

(1) ensuring that overseas investors are not charged to UK tax in relation to investment transactions conducted on their behalf; and

(2) that any fees earned by a UK investment manager for services performed for the non-resident should be fully chargeable to tax.

A UK investment manager must satisfy a number of conditions in order to qualify for the IME, as follows:

- it must be in the business of providing bona fide investment management services
- the investment transactions must be carried out in the ordinary course of that business
- the investment manager must act in an independent capacity in relation to those transactions
- remuneration must be on normal commercial terms i.e at the rate customary for such business
- the requirements of the '20% test' must be met i.e. the investment manager and its connected persons must not have more than a 20% beneficial entitlement to the income of the fund
- the UK investment manager is not the fund's UK representative in relation to any other income or transaction otherwise chargeable to UK tax for the same period

The most important point, however, is that the activities of the fund must amount to trading; the IME legislation has no relevance unless the fund is trading in the UK. Thus, if the fund is making long-term investments, it will not normally be subject to UK tax on its profits, despite the fact the UK investment manager is buying and selling the assets. Where there is trading in the UK, no assessment is due on the offshore fund when the IME applies. Instead, the liability of the fund is limited to tax deducted at source.

What amounts to trading?

HMRC in its Statement of Practice 1/01, which took effect on 20 July 2007, provides guidance as to what constitutes a trade. SP 1/01 makes it clear that:

- the active management of an investment portfolio does not constitute a trade
- short positions are viewed as conceptually the same as real positions
- neither short selling nor taking synthetic positions are in themselves indicative of trading
- if a non-resident carries on a financial trade outside the UK, any transactions carried out through a UK investment manager are likely to amount to trading in the UK

Despite the above, whether the fund is trading in the UK is ultimately to be determined on the facts of each particular case and advice should be taken.

The qualifying conditions

All of the qualifying conditions must be met and failure to meet any one of them, other than the 20% test, results in removal of the IME. If the 20% test is the only one failed, the exemption from tax is restricted. The following concentrates on clarifying certain aspects of the qualifying conditions in more detail:

Investment transactions

The investment manager must be carrying out investment transactions in the course of its business; thus, only those transactions which constitute investment transactions for the purposes of the IME will qualify.

The types of transaction which constitute an "investment transaction" are specified in the Investment Manager (Specified Transactions) Regulations 2009, as updated and amended by the Investment Transactions (Tax) Regulations 2014. The Regulations brought the range of qualifying investment transactions in line with those activities regulated by the FCA, including transactions in:

- stocks and shares
- securities
- options, futures and CFDs
- units in collective investment schemes
- buying and selling foreign currency
- loan relationships
- carbon emission trading products
- emissions of greenhouse gases
- rights under a life insurance policy

Independent capacity test

The relationship between the investment manager and the fund must be the same as between independent persons dealing with each other at arm's length. According to SP 1/01, HMRC will accept that the relationship is independent if either:

- the fund is 'widely held' within 18 months of being established; or
- the fund is being actively marketed so that it will become 'widely held'.

A fund will be regarded as widely held if either:

- no majority interest in the fund is held by 5 or fewer persons and persons connected with them, or
- no interest of more than 20% is held by 1 person or persons connected with them.

HMRC will also accept that the relationship is independent if the dealings between the investment manager and the fund do not constitute more than 70% of the investment manager's business. New investment managers have 18 months from the date of establishment to satisfy the 70% test.

If none of these tests is satisfied, wider consideration must be given to all of the circumstances relating to the relationship between the investment manager and the fund.

In the case of a master/feeder structure, the independence test will be applied by looking at the beneficial ownership of each feeder fund (as if the master fund were transparent). Similarly, in the case of an umbrella fund, HMRC will look at the beneficial ownership of each sub-fund.

The 20% test

The 20% test means that the investment manager and persons connected to it must not have a beneficial entitlement to more than 20% of the income profits of the fund arising from transactions carried out by the investment manager. The 20% excludes any fees payable to the investment manager, such as management fees and performance fees.

The 20% test is treated as satisfied if, over a 5 year period, the investment manager and persons connected to it have not been entitled to 20% or more of the chargeable profits of the fund. It is also treated as satisfied if the investment manager intended to meet that test, but failed to do so for reasons outside its control. If, for example, the investment manager was entitled to 32% of the fund's taxable income in Year 1, 29% in Year 2, 20% in Year 3, 14% in Year 4 and 2% in Year 5, the 20% test would have been met in Year 5, as the average percentage over the qualifying 5-year period would be 17% (as per HMRC's example in SP 1/01).

Where the 20% threshold is breached, the IME will still apply to that income to which the investment manager (and connected persons) are not beneficially entitled and that part will not be subject to UK tax. The excess, however, will not benefit from the IME and will be liable to assessment.

Interaction of the independence test and the 20% test

The independence test and the 20% test apply quite separately. If the investment manager is not acting in an independent capacity, then the 20% test will not apply as the IME will not come into play (as one of the qualifying conditions has not been satisfied) and the whole of the fund's income is liable to tax. If the independence test is satisfied, then the 20% test must be separately addressed. If the investment manager's interest in the fund is 25%, for example, then that share of the fund's income is liable to assessment.

Customary rate test

The IME requires that remuneration (i.e. management and performance fees) paid to the investment manager satisfy the 'customary rate test' and, although, 'customary' is not defined, the relationship between the investment manager and the fund must be the same as between independent persons dealing with each other at arm's length i.e. on a commercial basis.

HMRC has clarified that it will be guided by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations when determining whether a pricing structure applies the customary rate and will look at whether the net effect of any provision made or imposed by means of a transaction or series of transactions provide the investment manager with a level of remuneration which would have been achieved at arm's length. HMRC will take all circumstances into consideration, including whether remuneration has been reduced below the arm's length rate in any way either before or after payments to the UK investment manager.

The vast majority of investment managers and funds meet the customary rate test; however, HMRC will look closely at those structures whereby offshore arrangements, such as fees being diverted to an offshore manager at a non-arm's length rate, have been used to avoid or evade UK tax.

Conclusion

If the qualifying conditions of the IME set out above are satisfied, the transactions carried out by the UK investment manager will not be liable to UK tax. Where an investment manager undertakes non-qualifying transactions, the IME can still apply to those transactions which do qualify, albeit that it will not apply to those transactions where the qualifying conditions are not met.

The IME thus operates in a range of circumstances and ensures that the UK is a globally competitive jurisdiction for investment managers.

This document is for general guidance only. It does not constitute advice
January 2014

CUMMINGS
lawyers for alternative investments

42 Brook Street, London W1K 5DB +44 20 7585 1406 | Neuhofstrasse 3d, CH-6340 Baar +41 41 544 5549