

# Current tax Issues affecting managers and investors in Alternative Investment Funds

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## What are we going to talk about?

We will concentrate on tax aspects but don't forget other factors

In the context of the standard offshore model we will look at tax issues for:

- Fund vehicle and offshore manager
- Investment manager
- Principals
- Investors

We will also look at some onshore options now tax neutrality is possible

# I. Fund Vehicle and Offshore Manager

## Traditional model

Assume traditional model – hedge fund and fund manager established offshore (“offshore manager”)

May be other offshore entities

Want the hedge fund and other offshore entities to be outside the scope of UK tax:

- should be non-UK resident
- should not have a P/E in the UK

## UK residence tests for entities

UK residence test:

- incorporated in the UK
- has central management and control in the UK

Central management and control:

- derives from case law
- is a question of fact
- looks at where the highest level of control of the company takes place (as opposed to day to day management) so check (i) where directors take decisions and (ii) whether control has been usurped by third party/shareholder
- looks at the whole course of the company's business

## **Factors that HMRC consider**

HMRC assume control is where board meetings are held unless evidence that high level control in fact exercised elsewhere

Ensure that the board is not just “rubber-stamping” decision of others

Board decision should not be subject to approval by other person

UK directors should not have more power or influence than non resident directors

Easier to show HMRC that company is resident somewhere else than resident nowhere

## **Practical considerations**

Appoint majority non-UK resident directors with experience in relevant area

Ensure majority directors at meetings are non-UK directors

Hold board meetings at least quarterly and outside the UK with proper consideration of issues

Careful with phone attendance and written resolutions

Document all board discussions not just decisions

Avoid UK-resident alternate directors

## Type of fund vehicle

Fund vehicle: corporate/unit trust/partnership – transparent/opaque

US taxable entities: do not want an opaque vehicle as this would be a PFIC (unless QEF)

US exempt entities: do not want a transparent vehicle as it will generate UBTI

Solution: master/feeder fund



## Is the fund trading?

What is trading?

Case law-badges of trade including:

- motive
- number of transactions
- frequency of transactions
- interval between purchase and sale
- finance source

For years no statutory guidance on what trading was and case law not easy to apply to modern scenario

Hedge fund strategies assumed to be trading due to high turnover, use of derivatives, borrowing and short selling

## Is the fund trading? (2)

Now there is Statutory White List of non-trading transactions - any transaction by fund with GDO in:

- stocks and shares
- collective investment schemes
- foreign currency
- carbon emission products

Many hedge fund strategies can now be treated as non-trading

**BUT** only applies to AIFs and offshore AIF equivalents

**NB** not valid for deciding if IME is necessary

## II. Investment Manager

## Investment Manager

Non-resident company within the charge to corporation tax if it carries on a trade in the UK through a Permanent Establishment (“PE”) in the UK

No concern if fund not trading but White List not helpful in this regard

Could a UK investment manager create a PE in the UK? If fund is non-corporate vehicle, could UK investment manager be taxed as UK representative?

Without statutory relief the answer could be “Yes”

If there is UK adviser (rather than investment manager) then not treated as a PE or a UK representative but practical difficulties

## Investment Manager Exemption

To qualify for exemption (and therefore not be a PE or UK representative) fund manager must meet certain conditions:

- must be carrying on a business of providing investment management services.
- transactions must be carried on in the ordinary course of that business.
- manager acting in an independent capacity.
- manager and persons connected with the manager are not entitled to more than 20% of the fund's profits and gains
- customary remuneration

## Customary remuneration

Investment Manager must receive customary remuneration for that class of business

Arm's length fee structure within OECD TP guidelines will be customary:

- provided an appropriate TP methodology is used and adequate documentation is in place, any adjustment to arm's length price will not impact on IME
- receipt must be taxable in hands of manager

Issues where:

- reduced/rebated fees for some investors
- offshore entities
- no fee shares

## III. Principals

## Taxation of principals

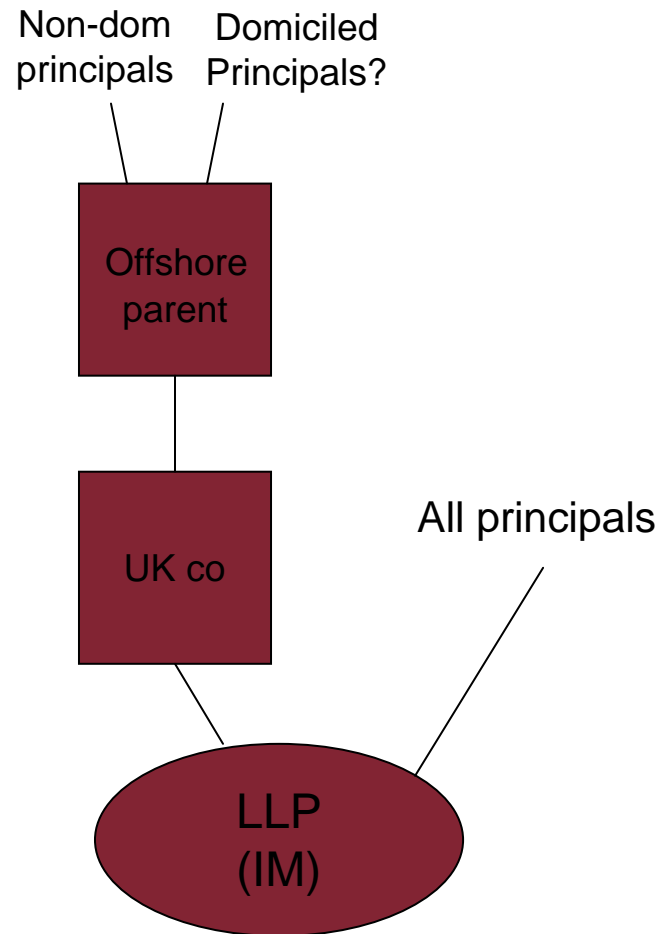
If company used as Investment Manager, CT of 24%. Tax on individuals of 25% (or 36.11% if 50% taxpayers) on dividends when paid out (30.6% in 2013 when 50% becomes 45%)

Common structure is for LLP to be formed with individuals and a corporate member owned by offshore parent

- if LLP used individuals will pay income tax at 40% or 50% (45% in 2013) plus NIC of 2% (though no employer's NIC). The corporate member is taxed at 24% on its share and then dividends it to offshore parent
- subject to anti-avoidance rules these amounts can then be paid to non-domiciled individuals with no UK tax
- consider whether also appropriate for UK resident/domiciled principals



## Taxation of principals



## **New UK residency tests**

Consultation issued in June 2011 on definitions of residence and ordinary residence, draft legislation still not issued, changes to take effect from 6 April 2013

Statutory residence test:

- Part A: factors that mean conclusively not resident (takes precedence over Part B)
- Part B: factors that mean conclusively resident
- Part C: if fall in neither of Part A or Part B

## IV. Investors

## Investor tax issues

### UK offshore fund rules

- what is an offshore fund?
- reporting funds exclusion

### Section 13 Taxation of Chargeable Gains Act 1992 imputation of capital gains

- 10% rule

## V. Onshore Options

## Onshore option?

Can UK fund regimes be used for hedge funds?

AIF taxation regime not suitable

- 20% tax on income
- highly regulated
- restrictions on borrowing and investments
- inefficient for non-taxpayers

Rule changes to fund vehicle taxation and regulation since 2009

- QIS
- TEF
- FINROF

## Qualifying Investor Scheme

QIS -10% rule replaced by Genuine Diversity of Ownership

GDO has three conditions

- the fund document has to specify that it can be marketed to a wide group
- there can't be any conditions which practically restrict that group to a smaller subgroup
- the fund must in fact be marketed to the group specified ( and if the fund in fact has a large number of unconnected investors then this condition is satisfied)

If GDO is not met, QIS treated as a close investment holding company and all gains and income are taxed at full corporation tax rate

Advance clearance available

White list for trading/non trading

## Tax Elected Funds

TEF treatment is elective and only available if fund has GDO

Point of taxation moves to the investor and is broadly tax neutral

- capital gains remain exempt (and cannot be distributed)
- income streamed between dividends and other income
- distribution in respect of dividends taxed as dividend and distribution in respect of other income is taxed as annual interest

While some income is taxable in the TEF (e.g. interest) the other “distribution” is deductible in the TEF so tax neutrality retained



## FINROFs

In 2010 new rules introduced for funds investing in non-reporting offshore funds (“FINROFs”)

Tax point moved to investors in FINROF

- UK resident investors in FINROFs taxed as income for any gain realised on disposal of the units
- attempt to tax investors as if they had invested directly in the non-reporting offshore funds

Not entirely successful

## Summary

- If non-tax drivers push some funds out of traditional offshore jurisdictions UK option available but not ideal
- Individual's tax regime in UK not ideal but still tax haven for non-domiciles
- IME in UK gives certainty to location for investment manager