

United Kingdom

Taxation

HEDGE FUNDS 2009

Hedge fund managers/advisors

Taxation

Tax rates applying to hedge fund managers/advisors

If the U.K. fund manager is incorporated as a company it will be subject to U.K. corporation tax on its taxable profits at a rate of 28 percent. Distributions to the owners of the business are taxed at an effective rate of 25 percent of the distribution received, resulting in a total effective tax rate of 46 percent. A small companies' corporation tax rate applies if the company's taxable profits in a 12-month period are less than GBP 300,000 divided by the number of associated companies. Marginal rates apply if the company's taxable profits in a 12-month period are between GBP 300,000 and GBP 1,500,000, again these bands are divided by the number of associated companies.

If the U.K. fund manager is established as a limited liability partnership (LLP), it is viewed as a see-through entity for tax purposes and the taxation liability will fall on the members of the LLP. A corporate member will be subject to corporation tax as detailed above. An individual member will be subject to income tax at their marginal rate (the top income tax rate is 40 percent plus national insurance of 1 percent).

The effective tax rate usually suffered by hedge fund managers/advisors

Most U.K. hedge fund managers are structured as an LLP with a corporate member and individual members. The effective tax rate is therefore a combination of the individual marginal rates and the corporation tax rate, but is generally around 41 percent.

There are no adjustments that are specific to hedge fund managers that impact on the effective tax rate.

Tax concessions, allowances, or exemptions specifically available to hedge fund managers/advisors

There are no concessions, allowances, or exemptions that are specifically available to U.K. hedge fund managers/advisors.

Details of anti-avoidance tax rules that could bring the profits of an offshore hedge fund into tax

The offshore fund's profits are likely to be brought within the charge to U.K. tax if either:

- it is managed and controlled in the United Kingdom; or
- it is traded in the United Kingdom through a permanent establishment.

Management and control

In determining where an entity is managed and controlled, the U.K. courts look at the highest level of control of the business and the place where the company's board of directors meet is indicative of the place of central control. So if the meetings of the directors of a company who exercise control over that company are held in the United Kingdom, this would point to the company being managed and controlled in the United Kingdom. If control is in fact exercised by a single individual, the place of residence of the company will be the place where that individual exercises his/her powers and not the place where the directors meet.

Trading through a permanent establishment

The tax legislation states that, if an offshore fund is considered to be trading (which is often the case for hedge funds) the offshore fund will have a permanent establishment in the United Kingdom if an agent (that is, the U.K. fund manager) acting on behalf of the offshore fund has and habitually exercises its authority in the United Kingdom to do business on behalf of the offshore fund.

However, the offshore fund will not be regarded as having a permanent establishment in the United Kingdom if the agent is of independent status acting in the ordinary course of its business. The legislation sets out five tests referred to as the Investment Manager Exemption (IME) which must be satisfied in order for the manager to be regarded as having independent status. If the tests are not satisfied, the profits of the offshore fund arising from the transactions of the U.K. fund manager will be subject to tax in the United Kingdom. If only the 20 percent test is failed (see below), the profits subject to tax are limited to the beneficial entitlement share of the U.K. fund manager and connected persons.

The investment manager exemption is only available to the extent that the manager carries out 'investment transactions'. Transaction in bonds, equities and most derivatives are investment transactions, but some transactions, for

example those in commodities, real estate and insurance contracts, are not investment transactions.

The five tests of IME are:

- The U.K. fund manager must carry on a business of providing investment management services.
- The transactions for the offshore fund must be carried out in the ordinary course of that business.
- The U.K. fund manager must act on behalf of the offshore fund in an independent capacity. This means that the relationship between the U.K. fund manager and the offshore fund must be at arm's length in terms of legal, financial, and commercial characteristics.
- The U.K. fund manager, together with connected persons, must not have beneficial entitlement to more than 20 percent of the profit of the offshore fund (referred to as the 20 percent test). This test may be satisfied if the beneficial entitlement does not exceed 20 percent in aggregate over a period not exceeding five years.
- The remuneration received by the U.K. fund manager for the provision of investment management services is at a rate which is not less than that which is customary for that class of business.

Requirements to charge VAT (or equivalent sales tax) and the rate

Under U.K. VAT legislation, a supply will only be subject to U.K. VAT if the place of supply is in the United Kingdom. Therefore where a U.K. fund manager is providing an offshore fund with investment management services, the place of supply of investment services is likely to be where the recipient is located (that is, where the offshore fund is established). The provision of investment management services by a U.K. fund manager to the fund is likely to be outside the scope of U.K. VAT with the right to recover input tax.

Hedge fund structures

Taxation

Tax rates applying to the fund

If an open-ended fund aims to attract a wide range of investors, the only suitable tax regime would be that for authorized funds (authorized unit trusts and open-ended investment companies). These are subject to tax on income but exempt from tax on chargeable gains. However, the regime is not suitable for the majority of hedge funds.

HM Revenue and Customs are likely to regard many hedge fund strategies as activities in the course of a trade, which means that gains would be subject to income tax and would not be exempt. To the extent that gains arise on loan relationships and derivatives and are accounted for on capital account, such gains would not be taxed. The uncertainty of this tax regime, coupled with the difficulty that hedge funds would have in getting FSA authorization, mean that the United Kingdom is not an attractive domicile for such funds.

The U.K. government has released a consultation paper outlining a proposed white list of financial transactions for authorized funds that will not be taxed as activities in the course of a trade. Subject to responses, the Government intends to introduce the legislation in late 2009. Should these new measures be adopted, the United Kingdom could become more attractive as domicile for certain types of hedge funds that is, those that meet the Qualified Investor Scheme (QIS).

Access to double tax treaties

If authorized, the fund would have access to a wide range of tax treaties.

Value-added tax registration and charging requirements

Authorized funds are not required to register for VAT. However, funds may choose to register if they are able to reclaim input tax suffered on certain expenses.

Withholding tax on dividends or interest payments

For unit holders in a Bond fund (broadly an authorized fund investing more than 60 percent of its assets in debt securities), interest distributions paid must have 20 percent tax deducted from the payment unless the unit holders are entitled to receive the distribution gross.

Other authorized funds pay dividend distributions. Dividend distributions carry a 10 percent tax credit, which is disclosed on the tax voucher sent to investors.

Upon realization of an interest in the fund, it is seen as a disposal for capital gains tax purposes.

Tax return requirements

An annual corporation tax return (CT600) needs to be submitted within 12 months of the accounting period end.

For bond funds that pay interest distributions, any income tax that is withheld on the interest distribution paid, needs to be accounted for on a quarterly return

(CT61). The payment deadline for any tax due is 14 days from the end of the period.

Investors

Taxation

Specific anti-avoidance tax legislation applying to an investor in an onshore fund

There are no rules specific for investors in U.K. hedge funds.

Specific anti-avoidance tax legislation applying to an investor in an offshore fund

There are three pieces of anti-avoidance legislation that could apply to a U.K. investor in an offshore fund:

The offshore fund rules apply if an investor has a material interest in a collective investment scheme (as defined by the U.K. Financial Services and Markets Act 2000). A material interest in an offshore fund is likely to be an interest in a collective investment scheme if the fund is open-ended (rather than closed-ended) and if it can reasonably be expected that the investor will be able to realize the market value of its interest within seven years of acquisition. The effect of the offshore fund rules is that any gain realized on the disposal of the interest in the offshore fund will be taxed as an income gain rather than a capital gain unless the fund applies for a distributor status. This is not feasible if the fund is trading and is a fund of fund and more than five per cent of the underlying funds do not have a distributor status. This means that any capital gains allowances such as the annual exemption for individuals and indexation allowance for companies will not be available. In addition, any loss on disposal will be treated as a capital loss and not available to offset any income gain.

The U.K. government has been consulting on a new offshore funds tax regime and Finance Bill 2008 provided the powers to enable the new regime to be introduced. Draft regulations released propose replacing distributor status with a new reporting regime. In addition, a new definition of an offshore fund will be introduced. This potentially will broaden the scope of the rules as the current seven year rule will be removed. The effect of the proposed new offshore fund rules are the same, whereby any gain realized on disposal in a non-reporting offshore fund will be taxed as an income gain rather than a capital gain. Subject to consultation, the new regime is expected to commence on 1 October 2009.

The controlled foreign company (CFC) rules can apply if the offshore fund is controlled by U.K. resident persons. The CFC rules require that where a U.K. corporate investor has a beneficial interest in the profits of the offshore fund of 25 percent or more (and where the fund is a CFC), a CFC apportionment may

be required to be made. The application of the CFC provisions is subject to a number of exemptions.

If the offshore fund invests in interest-generating assets and the total market value of those assets exceeds 60 percent of the market value of all investments at any point in an accounting year, then the loan relationship rules will apply to any U.K. corporate investors in the offshore fund. Where the loan relationship rules apply, the shares or units in the offshore fund will be treated for corporation tax purposes as a loan relationship and taxed on a mark-to-market basis, with the effect that any U.K. corporate taxpayers would be taxed yearly on increases in the value of the offshore fund.

HMRC has wide-ranging anti-avoidance powers which are designed to prevent the avoidance of income tax by individuals who are resident in the U.K. and who invest in offshore structures.

If the fund is a close company (broadly if it is controlled by five or few participators) any gains arising within the fund may be attributed to U.K. resident investors and assessable in the U.K. tax year that any such gain arises. For U.K. tax purposes the investor will be treated as if a part of the gain accruing to the fund had accrued to the investor instead. The amount of gain attributed would be proportionate to the interest that the investor holds in the Fund. These rules do not apply to investors who hold less than a 10 percent interest in the fund. If the fund falls within the definition of offshore fund, the one-ninth credit is not available.

There are other anti-avoidance provisions where the investor acquires an interest in an offshore fund if the fund is treated as receiving income (which may include investment income) as opposed to capital gains. To the extent that these provisions apply the individual investors will be taxed on the income received by the fund as if it were their income with credit given for any income tax paid on the same income. The legislation provides a defense to the anti-avoidance provisions where the investor can prove that the acquisition of the interest in the fund was a genuine commercial transaction and that the avoidance of tax was not the purpose or one of the purposes for the investment.

Tax information needs of investors

If the offshore fund makes a distribution, the U.K. investor will require details of the gross distribution and any foreign tax paid.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will

continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.