Deloitte.

Changes to UK tax residence rules

Greater flexibility for offshore fund structures and their managers

July 2014

Legislation has now been enacted that will exempt many non-UK incorporated funds from being tax resident in the UK. This article looks at the background to this development and the potential tax impact it could have on the offshore finance industry in Guernsey, Jersey and the Isle of Man ("the Islands"). We also briefly consider some potential legal and regulatory implications.

We conclude that this is a welcome change that will afford greater flexibility to funds in the Islands, and provides a competitive advantage over jurisdictions with no tax on income such as the Cayman Islands. However, any changes to the operation of fund structures carries risk, and tax and legal advice must always be considered.

Background

The Finance Act 2014 was enacted on 17 July 2014 and includes legislation that exempts certain non-UK incorporated alternative investment funds ("AIFs") from becoming UK tax resident even if the central management and control of the fund is carried out in the UK. This legislation has retrospective effect from 5 December 2013.

The existing exemption

Section 363A Taxation (International and Other Provisions) Act 2010 ("Section 363A") previously treated certain UCITS funds as not being resident in the UK if they were resident in another EU Member State for the purposes of any tax imposed under the law of that Member State on income. This provision was of no relevance to the Islands because our funds are outside of the UCITS regime.

The extension

The scope of Section 363A has been extended to include certain entities which fall within the definition of an AIF under the Alternative Investment Fund Managers Directive ("AIFMD").

Furthermore, the requirement for the fund to be an "offshore fund" (broadly speaking, a fund that is open ended or has such characteristics) is to be removed. This is a significant broadening of the exemption. The conditions to meet the extended Section 363A are as follows:

- the fund is a corporate entity;
- the fund is not incorporated in the UK or treated as a UK authorised unit trust;
- the fund is treated as resident in its foreign state for the purposes of any tax imposed on income, and;
- the fund is a UCITS authorised in a foreign state, or is an AIF which is authorised or registered in a foreign state, or is not authorised or registered but has its registered office in a foreign state.

The 'tax imposed on income' condition may appear to carve out tax exempt funds from the legislation but this is not the case. HMRC has confirmed to industry bodies that, where there is a tax on income in the foreign state, funds in that jurisdiction would fall within the definition even if they are tax exempt, so this would include funds located in the Islands. However, funds located in jurisdictions with no tax on income, such as the Cayman Islands, are not expected to fall within the exemption.

Purpose

AIFMD was introduced across the EU with effect from 22 July 2013 and imposes detailed rules on the way in which AIFs are managed and marketed in the EU.

The majority of funds in the Islands would be expected to fall within the definition of an AIF.

The level of substance and control that an AIF manager ("AIFM") must have over its AIF led to concerns that the AIF would become tax resident in the AIFM's jurisdiction. Accordingly, in order to protect their fund management industries, a number of EU states have already amended their tax legislation to prevent AIFs from being tax resident there as a result of the activities of their AIFM, and the UK is now following a similar course after undertaking a consultation last summer. This consultation came out of a package of measures being looked at by the UK as part of its 'Investment Management Strategy' which was announced in the 2013 Budget and which seeks to improve the competitiveness of the UK investment management sector.

The final provisions are very wide ranging, with no requirement to have a UK based AIFM to benefit from the exemption. This is consistent with the existing provision, where there is no requirement for the UCITS fund to have a UK based manager, and compares favourably to some other jurisdictions' rules on tax residence where (for example) the exemption may only apply in relation to local AIFM activities.

Impact on the fund

Many funds in the Islands take the form of corporate AIFs. A significant portion of these funds will have (or would like to have) some form of 'footprint' in the UK but hitherto there has always been a concern about the potential UK tax residence risk (for example caused by having a UK based director or related party advisor/ manager). As such, it is likely that many corporate funds may now wish to consider the impact of the extended Section 363A:

- Is it beneficial to the fund structure?
- How will it impact the way in which the fund operates in the future?

We consider below the potential impact Section 363A may have on funds in the Islands and their managers.

It should be noted that funds that are tax transparent such as limited partnerships will not be impacted and corporate partners of such funds (including general partners) will not fall within the terms of the exemption.

> The final provisions are very wide ranging, with no requirement to have a UK based AIFM to benefit from the exemption.

Fund domicile

The extension of Section 363A should not impact on where a fund chooses to be domiciled; being offshore remains as relevant as ever.

It is important to note that funds are domiciled offshore for a number of reasons, with tax neutrality being one of the key determining factors. A fund vehicle achieves 'tax neutrality' where its investors would be no better or worse off from a tax perspective from investing in the fund compared to investing in the underlying assets of the fund themselves.

A fund that is incorporated in the UK is treated as UK tax resident and is subject to UK corporation tax regardless of the Section 363A changes. As an example, an authorised investment fund is taxable in the UK at 20% on net income, with no tax on gains. Such a fund is required to distribute its net income as dividends each year and investors may suffer tax in their own jurisdiction accordingly. Investors would also suffer 0.5% UK stamp duty on purchase of shares in a UK fund (if not listed on a recognised growth market), whilst UK stamp duty typically does not apply to offshore funds.

There are other compelling reasons for funds to be domiciled offshore, such as an advantageous regulatory regime, flexible company law, specialist service providers and cost efficiencies.

The extension of Section 363A is unlikely to reduce the number of funds that are domiciled offshore. The reasons for establishing a fund vehicle offshore remain as relevant as they always have done. In fact, as explored in more detail below, there may now be a number of funds that will establish or re-domicile themselves in the Islands and as such Section 363A could provide a catalyst for new fund activity in the Islands over the coming months.

The Board of the fund

Whilst the extension of Section 363A may result in an increased presence of UK directors on the boards of offshore funds this will not be appropriate in many cases. The requirement for a well-diversified and experienced Board of offshore directors remains as important as ever in an increasingly complex legal, tax and regulatory environment.

Typically the Board of an offshore fund will comprise a number of directors with a majority being permanently based offshore. The Board will often be made up of one or two onshore directors (sometimes related to the onshore promoter, manager or adviser), with the remaining offshore directors typically sourced from legal counsel, the fund administrator and the local pool of non-executive directors ("NEDs") with relevant investment experience.

This mix of directors enables funds to establish a well-balanced, knowledgeable, experienced and diversified board who understand the offshore market and its legal and regulatory framework as well as the funds' investment strategies and underlying investments. This is a matter of good governance. The quality and mix of directors is something investors increasingly look at when considering their investment in a fund. As such, the extension of Section 363A may not have a significant impact on the composition of the Board as a whole.

However, the extension of Section 363A may result in an increased proportion of UK NED appointments to the Board in some circumstances. This may be the case particularly for funds with an unusual asset class where finding offshore NEDS with the relevant investment knowledge may be difficult, especially when potential conflicts of interest are considered.

Tax residence is not the only area of tax that offshore funds need to be aware of. There are a number of potential tax issues that could arise from management activities being carried on in the UK:

- Having substance in the UK could bring a fund onshore for VAT purposes. A VAT cost could arise either through non-recoverable VAT for the fund or non-recoverable VAT of the UK manager which passes this cost onto the fund. To prevent there being a UK VAT presence, the fund (and where relevant the offshore manager) must have the necessary offshore human and technical resources to manage and conduct the activities of the company to avoid any challenge that there is insufficient substance in either, or the risk that one creates a fixed establishment of the other.

- Trading funds run the risk of being subject to UK corporation tax if they trade in the UK through a permanent establishment and cannot avail themselves of the UK Investment Management Exemption ("IME"). The risk of creating a UK permanent establishment, the amount of income to be attributed to a UK permanent establishment, and the risk of not being able to benefit from the IME may all increase if offshore substance is not maintained.

- The level of substance that the fund has offshore may have an impact on transfer pricing, in particular the level of fees payable to a related party fund manager or advisor in the UK.

- Holding board meetings in the UK may give rise to potential employment tax (including PAYE) issues for offshore directors who physically attend those UK meetings, resulting in a tax compliance burden for funds and their offshore directors.

- In some circumstances the potential application of stamp tax may also need to be considered.

It is this broad range of potential UK tax issues that means having appropriate offshore substance remains critical to the tax efficiency of offshore based fund structures.

Impact on fund managers

Section 363A does not apply to fund managers, so those that want to remain offshore must continue to be alert to tax residence risks. For onshore fund managers, an increase in their activity might mean transfer pricing needs to be reconsidered. There are also VAT consequences, as discussed above.

Offshore fund managers

It is common for offshore funds to also have an offshore fund manager. This is often due to lighter touch regulation and more flexible company law however there can be significant tax advantages where there is appropriate substance offshore. It is therefore important that the position of the investment manager is considered when there is any change to the composition or operation of the fund board (particularly where there are mutual directors) to ensure that any tax benefits are retained.

Onshore fund managers

For onshore fund managers Section 363A is positive news. This is unsurprising as it is the sector the legislation was seeking to protect. It will give fund managers greater freedom to manage the activities of their offshore funds and this may lead to improved efficiencies in the operation of the fund.

However the relief provided protects the residence status of funds only. Onshore fund managers will still need to be wary of creating tax exposures for these funds such as a permanent establishment for corporation tax purposes or a VAT establishment. Any change to the activity of the onshore fund manager will also require consideration from a transfer pricing perspective.

UK regulation

Although Section 363A is being extended to alleviate tax residency concerns from the application of AIFMD, this could lead to issues with a fund structure's UK regulatory position.

For example, where offshore funds want to be considered self-managed under AIFMD, there is a danger that the fund may be seen to be carrying on regulated activity in the UK if it conducted all of its activities in the UK.

Opportunity

Section 363A may give rise to a number of opportunities that will benefit fund structures in the Islands, increasing the desirability of establishing fund structures in the Islands and reducing the barriers of doing so.

Certain funds may have been established in the UK rather than offshore because they could not easily or efficiently maintain non-UK tax residence. Common examples would include:

- The 'alternative alternatives' – funds that invest in a particularly unusual asset class where expertise in that asset class is not available offshore.

- Start up and small scale managers – where running a fund from an offshore location is impractical or costly. This issue is in part addressed by the use of platform fund managers but only a small minority of the offshore fund market makes use of such services.

- 'High maintenance' funds – where very regular interaction with the fund manager is crucial to the implementation of the investment strategy, for example hedge funds may fall into this category.

There is the possibility that the extension of Section 363A will see new funds being domiciled in the Islands by their managers, when before this was not a realistic option.

In an alternative scenario we may even see some funds with a UK connection re-domiciling from non-tax jurisdictions such as the Cayman Islands in order to fall within the Section 363A exemption. Again, this could be relevant to some of the hedge fund industry which is typically serviced out of the Cayman Islands.

From a practical perspective there are a number of potential benefits that the extended Section 363A offers:

- No need for UK directors to travel to offshore board meetings, resulting in cost savings for flights, conference facilities, hotels and hospitality.

- Easier to arrange and hold board meetings if UK directors can simply dial in.

Conclusion

The extension of Section 363A is a significant relaxation of UK tax rules in relation to the taxation of funds and will be of relevance to many funds in the Islands looking to manage their UK tax residency position. The exemption will give funds greater flexibility in how they operate and provides the Islands with a competitive advantage over jurisdictions with no tax on income such as the Cayman Islands.

However, tax residence is part of a number of tax, legal, regulatory and governance reasons for ensuring offshore fund vehicles maintain offshore substance and do not carry on activities in the UK.

It is not yet clear how offshore funds will react to this new legislation and we expect many will need to seek tax and legal advice if considering any change to the structure of their operations and the amendment of Articles and other key documentation to enable those changes to take effect.

If you would like to discuss the implications of Section 363A in more detail please feel free to contact us.

Jo Huxtable
Partner, Tax
Deloitte LLP – Guernsey
01481 703308
jhuxtable@deloitte.co.uk

Adam Hart
Senior Manager, Tax
Deloitte LLP – Guernsey
01481 703321
adhart@deloitte.co.uk

Designed and produced by The Creative Studio at Deloitte, London. 36743A