Update on tax developments and tax efficient deal structuring

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There is no doubt that the Channel Islands provide an attractive location for investment funds which can benefit from the specialised professional services sector which has developed here and the balanced level of regulation. Of course, tax planning will also be a key consideration.

However achieving a tax efficient structure is not something which follows automatically from establishing a fund offshore and the Channel Islands are not necessarily a safe haven from the scrutiny and potential challenge of outside tax authorities. Indeed, there are many aspects of an offshore fund's operations that, if not carefully managed and monitored on a regular basis, may jeopardise the tax status of the offshore fund.

It is no secret that HM Revenue & Customs (HMRC) are increasingly focused on residence and two high profile cases (Wood v Holden and News Datacom) have been decided in the courts in recent years. Although HMRC lost both cases, there is a general belief that HMRC will continue to look hard at offshore structures to identify areas of weakness and ideally to challenge these through the courts.

Under UK tax law, a company is resident in the UK if it is incorporated there or if that is its place of central management and control is there. The concept of central management and control has evolved through case law and a number of factors may be taken into account, such as:

(i) Location, attendance and substance of board meetings
(ii) Residence of directors
(iii) Extent of use of professional advisors and their locations
(iv) Who the key decision makers are
(v) Influence from other parties

In reviewing these areas factors, HMRC will look at the overall pattern of conduct and this may span a number of years.

If HMRC decide to challenge a structure, they may draw upon various sources of information as part of their investigation including the obvious formal documents such as board minutes, accounts and legal agreements but also the more informal evidence such as e-mails and telephone conversations linked to key individuals and notes from other management meetings. Not only could this information prove damaging if the roles and responsibilities of these individuals has not been properly defined and monitored, it is also a very time consuming and lengthy exercise to locate and produce the details required.

Reflecting for a moment on the recent court cases mentioned above, these centred predominantly on the substance of board meetings and whether these really constituted the place where key decisions were being made. In both cases, it was held that board meetings are indeed crucial in the determination of central management and control. Some obvious ways to improve the residence status of the offshore fund would therefore be as follows:

o Ensure all board meetings are conducted offshore
o All directors should attend in person - telephone avoidance is to be avoided and is a particular area on which HMRC have focused in practice
o It is preferable for a director not to attend a meeting than to attend by telephone from another location
o Board minutes should record all discussions and document the deliberations of the directors when, for example, considering the advice and recommendations of an investment advisor.

So let us assume that the residence risks have been properly addressed; the offshore fund is regarded as resident in its Channel Islands domicile, or more importantly and correctly, it is not regarded by any other jurisdiction as tax resident in that place. There is another pitfall for the offshore fund if it is trading and if the activities of the fund could be regarded as taking place through an investment manager or investment advisor located in another jurisdiction. A common example is the way in which an investment manager may take key decisions or carry out transactions on behalf of the fund. Similarly, an investment advisor may have authority to conduct business and/or take decisions on the fund's behalf.

Many tax authorities, including the UK, could take the view that the fund is trading through a permanent establishment and seek to tax the profits attributable to this establishment.

In the UK, this risk is often managed by the existence of the Investment Management Exemption (IME) which, as long as certain conditions are met, allows UK investment managers to trade on behalf of an offshore fund without creating a taxable presence in the UK. HMRC's interpretation of the IME is set out in their Statement of Practice 1/01 which, in its original version, provided the following main conditions:

(i) The manager is in the business of providing investment management services;
(ii) Transactions are carried out in the normal course of business;
(iii) The manager acts independently of the fund;
(iv) The 20% test is met - which is that the manager and persons connected to him are not entitled to more than 20% of the profits of the fund;
(v) The manager receives customary remuneration - this is the same as the arms' length principle commonly referred to in transfer pricing; and,
(vi) The manager is not the fund's representative in any other capacity.

Furthermore, the exemption only applies to 'investment transactions' which includes transactions in shares, stock, commercial paper, warrants, futures, options, currency, carbon emission credits, swaps and placing money at interest. It does not include transactions in land, investment banking type activities such as originating, negotiating or syndicating loans.

In the past, adherence to all of these conditions was of critical importance in order to avoid the 'cliff edge' scenario; whereby a breach of any one condition could lead to the whole of the fund's attributed profits becoming taxable in the UK.

This result was widely regarded as unfair since non-compliance was disproportionate to the potential tax liability and not consistent with the position in other countries. In July 2007, HMRC re-issued their SOP 1/01 on the IME, setting out their updated interpretation of the legislation and how they would seek to apply it in the future. The revised SOP is intended to be more wide ranging covering the customary remuneration test as well as providing additional comment on whether a fund is trading and how HMRC will apply the IME to certain transactions not falling within the definition of investment transactions.

The revised SOP states that taking a lead in arranging a loan syndicate, managing or originating a loan in which the fund is not a lender does not qualify as an investment transaction. However, where a UK investment manager undertakes capital raising or loan origination and receives taxable remuneration at arm's length, this will not be a breach of the IME. Credit default swaps, whether settled physically or in cash, fall within the definition of investment transactions. Futures and options relating to commodities that provide for physical delivery will be treated as investment transactions, as long as physical delivery does not occur.

The revised SOP confirms that an investment manager may undertake minor or inadvertent transactions that were previously not permissible, provided those transactions are taxed in the UK. This should save UK investment managers from the so called 'cliff edge' scenario.

When HMRC apply the customary remuneration principle they will look at the overall structure to determine if the net fees paid to the UK investment advisor or manager are representative of the value they add or the risks they take on behalf of the fund. The updated guidance confirms that where the appropriate transfer pricing documentation is in place the investment manager will have the opportunity to agree adjustments to the remuneration rate in order to meet the test without having breached the IME.

In the UK Budget 2008 the government announced some changes to the IME. Legislation will be introduced to simplify the approach to defining investment transactions. It was previously suggested that this simplification would be achieved through alignment with activities regulated by the Financial Services Authority, but instead a streamlined statutory process will be introduced to enable appropriate products to fall within the definition. Many will feel that the most important change announced in the Budget is that transactions failing to meet the definition of investment transaction will no longer cause the fund to fail the IME in its entirety. Instead, those specific transactions will be subject to UK tax. These changes are regarded as important steps in the simplification of the rules and will have effect from the date the Finance Act 2008 receives Royal Assent. This is likely to be summer 2008.

A final point to emphasise is that the IME is only relevant for a fund which is trading. Hence, an offshore fund which is simply investing in assets for capital appreciation, such as a long only fund, should have nothing to fear in this regard as it is not trading.

So, whether we are considering residence or trading, what all this boils down to is that other tax authorities will inevitably question structures using offshore funds where the result is the disproportionate accumulation of profits offshore.

We know that HMRC may question a structure where the Channel Islands fund manager retains a level of margin which is not commensurate with the skills or involvement of this party, especially when is it apparent that the parties which should really have earned these profits is in the UK. For example, a lack of performance fees payable to a UK investment manager may invite questions as to where these funds have been paid. HMRC would review the agreements and examine the roles of all parties within the structure to support their analysis.

In reality, HMRC may use UK's extensive transfer pricing legislation to challenge the attribution of profits within a structure and seek an adjustment of tax to address any perceived anomaly.

In conclusion, the role of the investment manager is often critical to the performance of the fund, but without careful planning and consideration the involvement of the investment manager can, in certain circumstances, compromise the tax efficiency of the structure. Similarly, the fund should be managed and administered in such a way to ensure that residence offshore is achieved in practice and this should remain a key consideration at all times.

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