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Sue Harper
Assets, Savings & Wealth
HM Treasury
1 Horse Guards Road
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11th June 2009

By email: sue.harper@hm-treasury.gov.uk

Dear Sue

Re: HM Treasury Consultation " Enhancing the competitiveness of UK funds" (April 2009)

The City of London Law Society ("CLLS") represents approximately 13,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of HMT's consultation "Enhancing the competitiveness of UK funds" has been prepared by the City of London Law Society's Revenue Law Committee. The Revenue Law Committee is grateful for the opportunity to comment on the consultative document.

Chapter 1 – summary of tax and regulatory changes

We welcome the steps that the Government has taken to improve the tax treatment and competitiveness of UK funds. Nevertheless, we are concerned that the UK may retain its image as a suitable jurisdiction only for funds intended primarily to be marketed to UK investors. We consider that further efforts must be made, particularly in the light of the European Commission's draft directive for alternative investment fund managers, to develop the position of the UK asset management industry so that the UK is the jurisdiction of choice within the EU in which to establish funds of all types and from which to obtain fund management and associated services. This will require certainty and simplicity of treatment for regulatory and tax purposes.

The Government should also continue to develop its proposals for streaming income of investment trusts in order to strengthen that sector of the UK financial services industry.

The tax regime for UK funds has evolved on the principle that UK resident investors should be taxed on the fund's income as it arises. Although this provides tax neutrality, it has resulted in a regime which is more complex and so unattractive when compared to the full tax exemption adopted in competing jurisdictions. In particular, it requires information, as determined for UK tax purposes, to be provided to all investors, either in the form of tax vouchers relating to distributions or deemed distributions of AIFs or under the reporting requirements for TEFs. This may not be necessary or suitable for investors resident outside the UK. Such information is not required to be provided by jurisdictions with which the UK is competing, whether the offshore fund locations or EU member states such as Ireland and Luxembourg. Rather, the manager's concern should be to provide the information required in their jurisdictions by the investors to whom the manager is marketing the fund. The proposal to permit a TEF to provide simplified information to investors, coupled with internet access to detailed information if the investor requires it, goes some way to achieving this.

However, that would remain an unnecessary compliance requirement for a fund which is marketed entirely to investors that are tax exempt institutions or resident in a jurisdiction that does not require such information. If the UK is to attract such funds, there is need for a second, parallel fund regime, under which the fund would be fully exempt from tax. As under the reporting funds regime contained in the offshore funds legislation, such a fund might elect (on a share class basis) either to be tax transparent as to income (in which case it would provide information to investors and UK resident investors would be taxed accordingly on their share of the fund's income) or to be tax opaque as to income (in which case UK resident investors would be charged to tax as income on their gains on realising their interest in the fund and on any actual distributions made by the fund). While such a tax exempt fund would generally not be eligible for the benefit of the UK's tax treaties, that is not a significant concern for many offshore funds currently. We expect that the Government would wish to consider whether this parallel tax regime should be restricted to funds that are not available to retail investors.

Such a parallel tax regime would permit the UK to be a fund jurisdiction for hedge funds and other alternative funds which recognise in their accounts dealing income from their transactions in financial instruments and so would not (it seems) be protected from the charge to UK tax on trading income, even under the trading or investment white list provisions. Please see our comments on this (at **Chapter 3 – trading or investment** below) in relation to AIFs.

The position of funds of funds investing in non-qualifying offshore funds must be resolved. This is a significant sector which cannot at present be represented by UK funds.

We understand that the charge to SDRT under sch 19 Finance Act 1999 raises about £50 million pa; it must cost the industry approaching the same amount in compliance costs. Although there is an exemption for funds investing in non-UK assets, these do not assist all funds, particularly funds of funds. The existence of the charge is at the very least a disincentive to use the UK as a fund jurisdiction, all other factors being equal.

Accordingly, our recommendations are that:

- The Government should consider whether UK funds – probably only QIS or other funds not marketed to retail investors - should be permitted to elect to be treated for tax purposes in the same way as offshore funds, ie the fund would not be taxable on its income or capital gains and its investors would be charged to income tax on gains from the disposal of interests in such a fund unless it opts for reporting fund status;

- The treatment of offshore income gains realised by UK funds must be addressed. Until this is resolved, the funds of funds sector will be limited in its ability to use UK funds;

- The Government should abolish the charge to SDRT under sch 19 Finance Act 1999.

Chapter 2 – Tax Elected Funds

We have made some general observations on the TEF regime in the first part of this letter. We note that the TEF regime closely follows the provisions of the PAIF regime. Our comments on the draft regulations are set out below:

- **69Z45:** we comment on the genuine diversity of ownership condition at **Chapter 3 – trading or investment** below.

- **69Z46:** does the property condition prevent a TEF from holding loans or debt securities secured by mortgage?

- **69Z49:** is it correct to refer to "unit holder" in (2)? By regulation 5(3) this is limited in application to a participant in a unit trust scheme, although the term "units" is more widely defined in regulation 6(4).

- **69Z51:** the same point concerning "unit holder" applies to (3)(d).

- **69Z56 & 69Z58:** as drafted, these place UK company distributions within TEF distributions (dividends) and overseas company distributions within TEF distributions (non-dividend). We assume that this will be amended in conjunction with the enactment of the foreign profits provisions.

Chapter 3 – trading or investment

We welcome the "white list" of investment transactions as bringing increased certainty to the tax treatment of AIFs and recognise that the Government should limit potential abuse by limiting it to AIFs which satisfy the genuine diversity of ownership condition and by requiring investors that are financial traders to adopt a fair value accounting basis for tax purposes (if not already the case).

Genuine diversity of ownership condition (new Part 1A)

We agree that the genuine diversity of ownership condition should be a standard test that applies for the purposes of the white list, the PAIF tax regime and the QIS tax regime. We note, however, that HM Government must have regard to its operation and ensure that, in applying the white list and the genuine diversity of ownership condition to offshore funds for the purposes of the reporting funds regime, offshore funds and their investors are not made subject to unlawful discrimination.

We believe that draft regulation **9A** effectively restates more concisely the provisions of current regulation 69J. We are pleased that the treatment of a feeder fund is extended to other AIFs as well as PAIFs. We welcome the retention of the clearance procedure for the genuine diversity of ownership condition (draft regulation **9B**).

Diversely owned AIFs (new Part 2B)

The effect of draft regulation **14E** is that a diversely-owned AIF cannot be charged to corporation tax on income as the profits of a trade in respect of amounts derived from transactions to which the white list applies. While this protects an AIF which accounts for profits from "investment transactions" as tax-exempt capital gains from having such profits re-characterised as taxable income, it is not clear what the position would be of an AIF that (however unlikely it may be in practice) actually carried on a financial trade and showed the dealing profits in its accounts as an amount in the nature of income (compare regulation 12):

- would such profits be untaxed in the hands of the AIF, on the basis that, as actual trading profits, the effect of regulation 14E is that they can be taxed only as such (or as capital gains, on which

the AIF is exempt) so that no residual charge to tax is available? In that case, the AIF would have income available for distribution which could be eligible to be treated as a dividend distribution and as such would carry a tax credit when no tax had been paid; or

- would such profits be taxed in the hands of the AIF as miscellaneous income (under s.979 CTA 2009)? This would avoid the creation of an unfunded tax credit on the AIF's distributions but the same deductions and reliefs may not be available to the AIF for its expenses as if it were taxed as carrying on a trade or as an investment company.

The amendment to regulation **95** similarly makes it clear that a diversely owned AIF is party to its loan relationships other than for the purposes of a trade, but leaves open the possibility of actual dealing profits being taxed as non-trading profits because (i) they are prevented from being trading credits and (ii) they are not protected from tax as capital profits within regulation 10.

While it may currently seem unlikely that an AIF would carry on an activity the profits of which would not be accounted for as capital profits within the meaning of regulation 12, this would need to be considered in the context of a QIS fund established to replicate certain hedge fund strategies.

Draft regulations **14F – 14L** reproduce regulations 4 – 11 of the Investment Manager (Specified Transactions) Regulations 2009 with minor consequential amendments (although in regulation **14G** the draughtsman has reversed the order of paragraphs (8)(a) and (b) for no obvious reason). This seems appropriate.

The anti-avoidance provisions in draft regulations **52B and 52C** achieve the Government's stated aim.

Yours sincerely

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Chair
Revenue Law Committee

cc.Lee Harley, CT & VAT, Financial Products and Services, HM Revenue & Customs

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REVENUE LAW COMMITTEE

The City of London Law Society is the local Law Society for solicitors practising in the City of London. It has a number of specialist Committees, the Revenue Law Committee being one of them. This response has been prepared and reviewed by the Revenue Law Committee as a whole.

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