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UK Tax Law Changes May Affect Fund Industry

January 7, 2013

Recently proposed changes in UK law could affect private investment funds that operate or have partners, employees or investments in the UK. Many of the proposed changes are included in the draft Finance Bill 2013, which was published on December 11, 2012 and is subject to public comment through February 6, 2013.

On the positive side, certain UK marginal tax rates will decline as of April 2013, with an additional reduction in corporate tax rates proposed to take effect as of April 2014. In addition, proposed rules clarify when an individual qualifies as a UK resident for tax purposes, which should remove much of the current uncertainty as to the tax status of fund managers working regularly in multiple jurisdictions. Proposed changes also relax the rules applicable to UK tax on gains from closely held overseas companies and other overseas assets.

On the other hand, a proposed general anti?abuse rule (the "GAAR") would permit HM Revenue and Customs ("HMRC") to adjust tax liabilities when a transaction has been structured for the principal purpose of UK tax avoidance. The GAAR could add a degree of uncertainty to structuring tax-efficient transactions in the UK.

Finally, legislation published on December 18, 2012 will ease the burden of UK private equity funds and other financial institutions seeking to comply with the US Foreign Account Tax Compliance Act.

This alert outlines some key changes either scheduled to take effect in April 2013 or that currently are under consideration.

Certain UK Tax Rates Decline

Corporation and Business Taxes

Effective April 1, 2013, the UK's corporate tax rate will decline to 23% from the current 24%. Under Finance Bill 2013, the corporate tax rate will fall further, to 21%, effective April 1, 2014. The UK's small profits rate, applicable to annual corporate profits of £300,000 or less, will remain at 20%.

National Insurance Contributions (NICs) and value-added tax (VAT) rates will remain the same.

Personal Taxes

Effective as of April 6, 2013, the marginal tax rate on ordinary income in excess of £150,000 will decline from the current 50% to 45%. Also effective as of April 6, 2013, the equivalent rate for dividends will decline to an effective rate of 30.55%. The 20% basic marginal tax rate (on ordinary income up to £32,010 for the 2013/14 tax year) and 40% higher marginal tax rate (on ordinary income above £32,010 up to £150,000 for the 2013/14 tax year) will remain unchanged.

The main capital gains tax rate remains at 28%, and the annual exempt amount will be £10,600 for the 2013/14 tax year. To date, HMRC has not proposed imposing ordinary income tax rates on carried interest paid by private investment funds, as has been discussed in the US.

General Anti-Abuse Rule Would Adjust Tax Liabilities for Taxpayers Using Abusive Tax Avoidance Schemes

The GAAR contained in Finance Bill 2013 permits "just and reasonable" adjustments to a taxpayer's tax liability if the taxpayer enters into arrangements that (i) have a main purpose of obtaining a tax advantage, and (ii) "cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions, having regard to all the circumstances."

The test does not state specifically that the arrangements must be "abusive," but it is becoming clearer from official guidance and responses to prior public comments that this is the intended target. In particular, the legislation now refers to arrangements involving "contrived or abnormal steps" (although it is not limited to this). Helpfully, the proposed legislation also now indicates that the GAAR should not apply to transactions in line with established industry practice.

It is still unclear exactly what types of arrangements are more likely to be scrutinised and if, and the extent to which, any structures used within the private fund industry may be challenged under the GAAR. The risk of the GAAR being imposed may significantly hinder use of new or unusual tax-efficient structures.

As proposed, the GAAR will apply to arrangements entered into after Royal Assent to Finance Bill 2013 and will apply to all UK taxes except VAT, stamp duty and stamp duty reserve tax (although it does apply to stamp duties on land).

Definition of "Resident" Clarified

On December 18, 2012, HMRC published guidance on when an individual is considered a resident within the UK for tax purposes. The new test will apply for tax years beginning April 6, 2013.

The test can be divided into three parts. There are automatic tests for residence, automatic tests for non-residence and "connection" tests for those who do not fall within one of the first two categories. The automatic tests for residence are, broadly speaking, based on day counting in conjunction with the use of a UK home or UK employment. The automatic non-resident tests are based on day counting in conjunction with employment and previous period of UK residence or absence thereof. The connection tests combine day counting with various ties to the UK such as work, accommodation and family.

In addition to the new test for residence, the concept of "ordinary residence," where an individual is deemed to have his or her settled home in the UK, is to be abolished in most cases. However, "overseas workday relief," where an individual is taxed on income from work performed overseas for a UK employer only if it is brought back into the UK, will be retained for certain individuals who, broadly speaking, meet the previous requirements for not being an ordinary resident of the UK. Internationally mobile fund managers who work both in the UK and abroad may be in a position to take advantage of this relief and ensure that their earnings from overseas work are not subject to UK tax. Accordingly, the retention of this relief is welcome news.

New Exemption Limits Direct Taxation of Owners of Closely Held Overseas Companies

Under section 13 of the Taxation of Chargeable Gains Act 1992, certain owners of closely held overseas companies (generally those controlled by five or fewer shareholders) are taxed directly on the company's gains. As a result, the gains of a closely held overseas manager, general partner or holding company could be taxed directly to its UK resident owners. The Finance Bill 2013 would exclude from such direct taxation gains from "economically significant" activities where there is no tax avoidance motive. This exclusion is intended to conform section 13 with current EU law.

The proposed change is clearly beneficial to owners of overseas companies that provide traditional goods and services. However, it is not totally certain how they will apply to investment businesses. In a previous draft of Finance Bill 2013, gains from the "making or holding of investments" were specifically excluded from being "economically significant". Although this exclusion has now been removed, the draft still refers to the provision of goods or services as a prerequisite to carrying on "economically significant activities." In this respect, the proposed draft may still be at odds with EU law.

Finance Bill 2013 also raises the threshold at which owners of closely held overseas companies may have gain allocated to them from 10% ownership to 25% ownership (with the ownership of affiliated parties combined).

New Exemption Facilitates Transfers of Overseas Assets

Chapter 2 Part 13 of the Income Tax Act 2007 taxes UK resident individuals on income paid to a person or entity abroad that is derived from assets transferred overseas by the UK resident where the UK resident retains the "power to enjoy" the income. Chapter 2 may come into play, for example, when individuals set up companies to receive their income overseas and still regularly use the income by making purchases or otherwise acting through the company. In theory, Chapter 2 could impact fund investors who invest through overseas entities or even fund investors who invest directly in opaque funds. UK individuals with interests in certain overseas general partner structures also may need to consider how this regime affects them.

Fortunately, UK taxpayers are exempt from Chapter 2 as long as avoiding UK tax is not a main purpose of the payment arrangement. This exemption usually applies in a funds context.

Finance Bill 2013 would add a further Chapter 2 exemption, which would apply if the taxpayer can show that, when viewed objectively, (i) the income in question is attributable only to "genuine transactions," and (ii) UK taxation of that income would constitute an unjustified and disproportionate restriction on EU treaty freedom. As is the case with the section 13 changes discussed above, this change is intended to comply with EU law.

Finance Bill 2013 includes provisions to help define what constitutes a "genuine transaction," including that a transaction must be made either entirely for personal reasons or, if for commercial reasons, must be on arm's-length terms and (in the case of structures involving overseas business establishments) involve the provision of goods or services. As a result of the "goods and services" requirement, it is not yet clear that the new exemption would apply where UK taxpayers have interests in overseas investment business structures. As is the case with the section 13 changes discussed above, these proposed changes also may not comply with EU law.

Although Chapter 2 generally is inapplicable due to the existing "motive" exemption, the additional exemption contained in Finance Bill 2013 may make it even less likely to constitute a problem.

Legislation Would Ease FATCA Burden

In September 2012, the UK became the first country to enter into an Inter-Governmental Agreement ("IGA") with the United States in relation to the implementation of the US Foreign Account Tax Compliance Act ("FATCA"). Subsequently, HMRC requested comments on how the IGA should be incorporated into UK law. On December 18, 2012, the government published a response to comments, together with draft legislation and guidance on the implementation of the IGA. Comments by February 13, 2013 are invited.

Broadly speaking, the IGA allows UK resident financial institutions to fulfill the reporting requirements of FATCA by reporting to HMRC rather than to the US Internal Revenue Service. The IGA also allows for less onerous due diligence requirements than those in FATCA. The original IGA was somewhat unclear in certain key areas relevant to the private fund industry, and the draft legislation and guidance have addressed some concerns, although others remain outstanding.

The draft legislation confirms that a partnership will be regarded as a UK resident under the IGA if the "control and management of the business of the partnership as a reporting financial institution" takes place in the UK. Accordingly, partnerships regarded as managed and controlled in the UK will be within the scope of the IGA. However, funds that are organised in the UK but not managed and controlled there will not be able to use the UK IGA, although they may be covered under an alternative one.

For example, an English or Scottish limited partnership with a Guernsey manager and general partner is likely to fall outside the UK IGA but may be within an IGA between the United States and Guernsey. However, since this definition of a partnership's residence is to be implemented by virtue of UK law, it remains an open issue whether or not other jurisdictions will adopt the same approach. If, for example, Guernsey were to enter into an IGA and were to state that it regards a partnership as being resident in Guernsey only if it is constituted or organised in Guernsey, an English or Scottish limited partnership with a Guernsey general partner and manager could fall outside both IGAs. Conversely, a Guernsey limited partnership with an English general partner and manager could find itself obliged to report under both IGAs. This is an area to watch.

The draft legislation does not address the issue of the need for possible multiple reporting in fund structures, given that many entities within such structures may be regarded as financial institutions. However, the guidance offers some assurance in this area. It states that entities that are financial institutions only by virtue of "investing, administering or managing" a reporting collective investment vehicle will not be regarded as having financial accounts for which identification and reporting are required. The scope of this is not entirely clear and requires additional clarification.

The draft legislation leaves open certain important questions as to the format for registration and for submission of data. These should follow in due course. HMRC also has stated that it is still considering an equivalent requirement to the "responsible officer" in FATCA so that it may be that funds are required to appoint a "point person" with whom HMRC can discuss IGA compliance.

These new documents provide some clarity in relation to the implementation of the UK IGA but interaction with other potential IGAs remains an area of concern – and possible multiple reporting may yet represent an issue.

Conclusion

Many of the changes proposed in the UK Finance Bill 2013 and otherwise likely will affect and may be beneficial to the fund industry. In instances where there is a lack of clarity, the public comment process may well serve to improve upon the current draft proposals. Please contact your Proskauer relationship lawyer for more information.

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