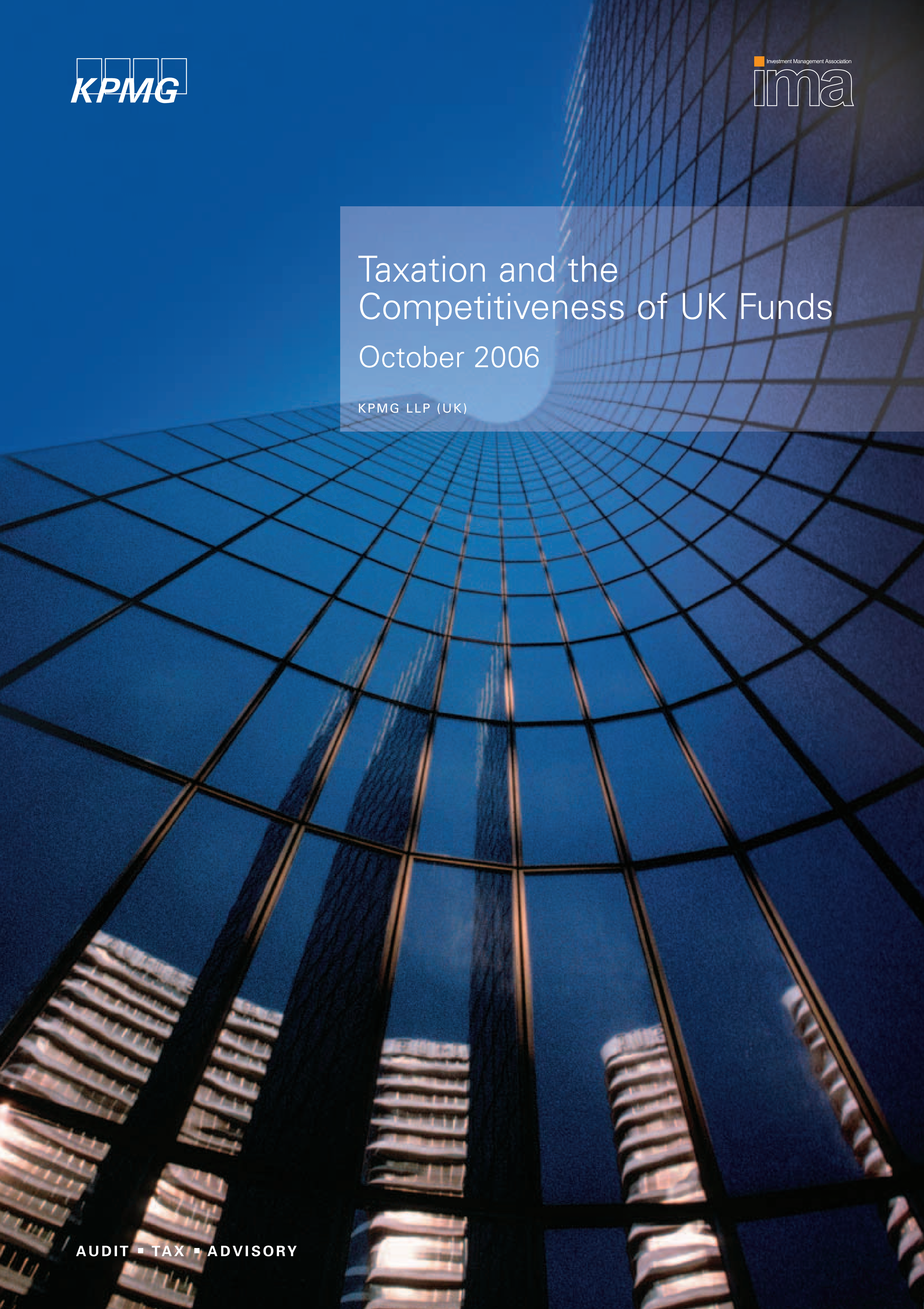


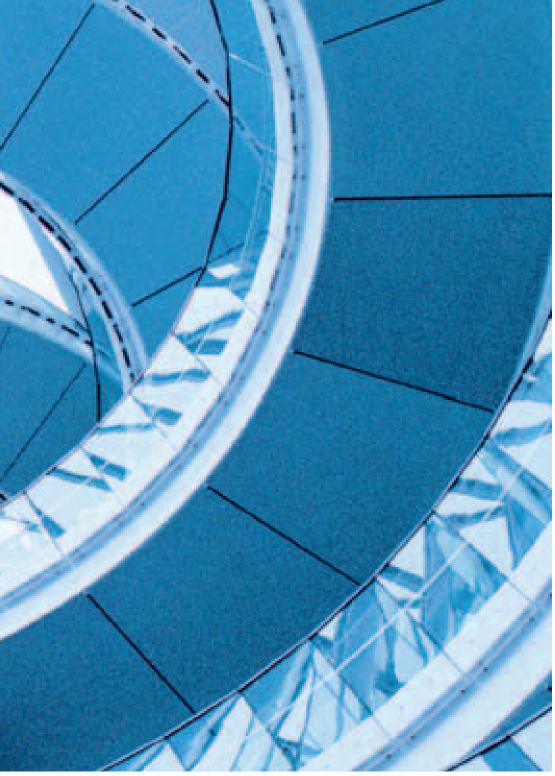
Investment Management Association

Taxation and the Competitiveness of UK Funds

October 2006

KPMG LLP (UK)

AUDIT ▪ TAX ▪ ADVISORY



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Abbreviations

AIF	Authorised Investment Fund
AITC	Association of Investment Trust Companies
AUT	Authorised Unit Trust
CCF	Common Contractual Fund
CESR	Committee of European Securities Regulators
CIV	Collective Investment Vehicle (see Section 2.3)
ECJ	European Court of Justice
EFAMA	European Fund and Asset Management Association
ETF	Exchange Traded Fund
FA	Finance Act
FCP	Fonds Commun de Placement
FUM	Funds Under Management
HMRC	HM Revenue and Customs
HMT	HM Treasury
ICTA	Income and Corporation Taxes Act 1988
ICVC	Investment Company with Variable Capital
IMA	Investment Management Association
NURS	Non-UCITS Retail Scheme
OEIC	Open-Ended Investment Company
PFPS	Pension Fund Pooling Scheme
PFPV	Pension Fund Pooling Vehicle
QIS	Qualified Investor Scheme
SDRT	Stamp Duty Reserve Tax
SEC	Securities and Exchange Commission
SICAV	Société d'Investissement à Capital Variable
UCITS	Undertaking for Collective Investment in Transferable Securities
UUT	Unauthorised Unit Trust
VCIC	Variable Capital Investment Company

Foreword

It gives us great pleasure to present this report on behalf of the Investment Management Association (IMA) and KPMG LLP (UK).

The UK remains a vibrant and leading investment management centre, with a significant and strong domestic market. It is still the location of choice for most of the core investment management activities within Europe, and is the leading European location for hedge fund managers. However, the last 10 years have seen significant growth in the number of funds and assets based in Luxembourg and Ireland, in part at the expense of the UK.

Between 1995 and 2005 fund assets domiciled in Ireland and Luxembourg grew 31 and six times respectively, while the UK saw only a three-fold increase. In addition, in the last two years there has been greater penetration of the previously parochial UK domestic market by non-UK domiciled funds. Many in the industry believe that taxation is a major factor driving this trend. The IMA therefore commissioned this report to test this claim and to consider the impact on the UK funds industry and the wider economy of allowing this trend to continue. In compiling this report, KPMG has conducted primary research with firms managing in excess of 60 percent of UK authorised funds.

By most measures, the research has concluded that the UK tax regime for funds is not competitive compared to Ireland and Luxembourg. There are specific technical tax reasons for this view, but also a pervasive lack of confidence and trust in the UK tax system.

UK based investment managers are frustrated by this situation, and there is a feeling amongst managers that urgent positive action is required if the UK industry is successfully to defend and grow its position in the future. While there exists significant opportunity to build on current market strength, through selling UK domiciled funds into the EU (as a small minority of UK based managers have already done) and positioning the UK as an attractive fund domicile for alternative asset funds, this will not happen without a proportionate tax regime. The desired outcome for the industry is a simpler tax regime able to compete directly with Ireland and Luxembourg, backed by supportive and constructive tax and regulatory authorities.

This would not only strengthen the UK investment management and financial service sectors, but would also benefit the wider UK economy. A successful industry results in the retention and growth of UK based administration-related jobs that are currently being lost to other domiciles. Furthermore, a simpler taxation position for funds would be more easily understood by the public, supporting the Government objective to increase UK public confidence in the UK savings market and helping to facilitate greater savings towards retirement.

We believe that the UK authorities are showing a renewed willingness to engage with such issues, as shown for example by the announcement in the 2006 Budget of a new initiative to promote the UK as a financial centre. The recommendations in this report are offered as a constructive contribution to the debate flowing from that announcement, and we hope they will form the basis for a future dialogue to ensure the maintenance of a competitive environment for the UK investment management industry going forward.

Richard Saunders, Chief Executive, IMA and Jane McCormick, Head of Tax, Financial Services, KPMG LLP (UK)

Executive summary

1.1 Introduction

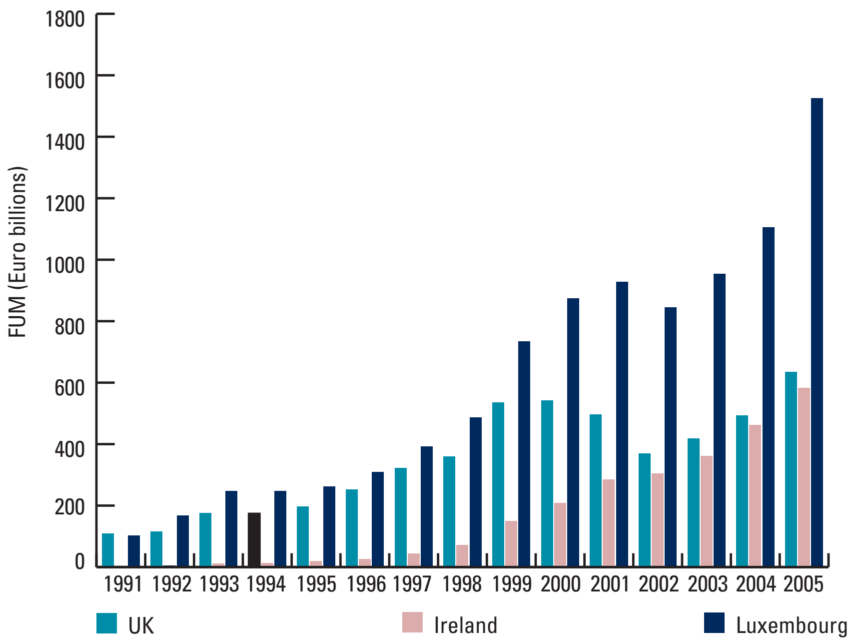
The IMA has commissioned KPMG to consider the influence that taxation has on the fund domicile decision, and the further impact this has on the competitiveness of UK funds and the wider UK economy. In preparing this report, KPMG has conducted interviews with 26 investment management groups and four administration companies. The investment management groups interviewed together manage over 60 percent of UK authorised funds as at 31 May 2006.

1.2 The growth of UK domiciled funds lags behind Luxembourg and Ireland domiciled funds

Offshore fund centres in Luxembourg and Ireland have grown significantly in the last 10 to 15 years and are now firmly established as the leading EU locations in which to domicile funds intended for cross-border sale.

The growth of Luxembourg and Ireland has been fuelled by offering either retail funds that can be sold within many European and global markets (Luxembourg) or by offering more specialist fund types targeted primarily at institutional investors (Ireland). By comparison, UK domiciled funds have grown at a far slower rate, with the underlying growth in the UK funds market being partly offset by the increased penetration of offshore funds (see Figure 1.1). In addition, UK funds do not have a significant share of the non-UK funds market.

Figure 1.1
Growth in registered fund assets



Source: EFAMA and IMA (figures include UCITS and non–UCITS funds)

1.3 The UK market is approaching a tipping point

UK domiciled funds will remain, in the short term, the fund of choice for the mainstream UK market, both for historical reasons of familiarity and because there is often little tax or other differential between UK and comparable offshore funds.

However, in the medium term, the position of UK domiciled funds is less secure as products continue to evolve in areas where conspicuous tax differences do exist and offshore funds gradually become more widely accepted in the UK market. Since changes were made to the offshore funds tax legislation in July 2004, which helped open up the UK market, Luxembourg and Ireland based funds' share of net sales of the UK market has increased from one percent to 21 percent[1]. As firms increasingly look to optimise the number of fund ranges, offshore ranges may become the single range of choice and consequently further economic benefits would be lost to the UK.

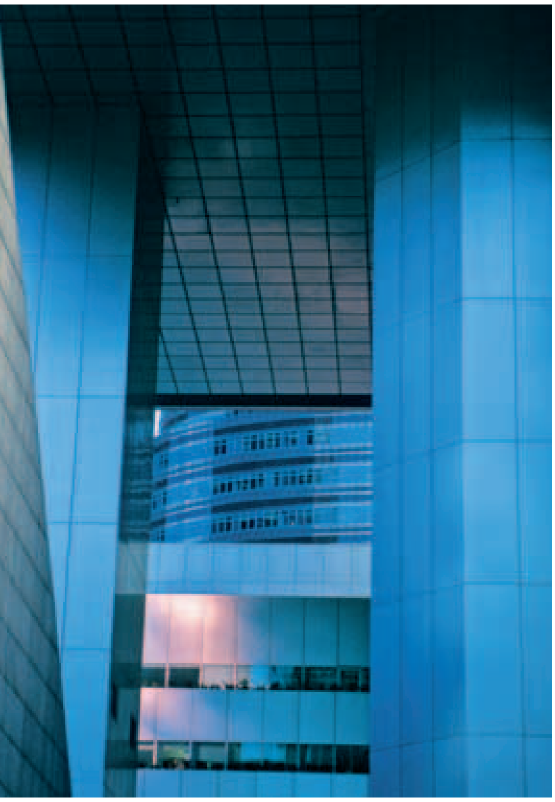
1.4 The EU domicile of choice for more complex products is not yet established

The more complex products (that this report terms alternative or progressive products, for example, property funds, hedge funds, and Undertakings for Collective Investment in Transferable Securities (UCITS) using derivatives) now represent the major industry growth area. However, managers rarely select the UK as a fund domicile for these products. This is due to a combination of actual tax differences and perception, with investment managers viewing the UK tax authorities more as an obstacle to, rather than supporter of, industry development and growth.

By contrast, in other fund centres, tax and regulatory authorities are often considered more supportive of the industry, in particular facilitating new developments and innovations. This in turn enables those centres to attract new funds with the related employment and overall economic benefits.

While there certainly exist preferred EU domicile locations for these products, there is as yet no clear EU domicile of choice. There is still sufficient time for the UK to establish itself as a viable fund domicile centre, particularly through the ability to leverage existing expertise and strength in core investment management and related activities for more complex products (for example, the UK is the European centre for hedge fund management, managing around 70 percent of European hedge fund assets[2]).

1 Source: FERI FMI
2 Source: Goldman Sachs



1.5 Taxation has a significant influence on fund domicile

Taxation efficiency and the regulatory environment are significant factors managers consider when selecting a domicile for a new fund. Within this, managers consider the approach and attitude of the tax authorities to be of equal importance to the detailed tax rules and regulations.

For the more established fund types, managers will generally have experience of, and understand, the selected domicile tax regime. For such funds, the focus is on ease of process and ensuring that there are no new or predicted changes to the regime to alter their basic understanding and position. Taxation is more often considered implicitly rather than explicitly.

However, taxation is of increasing importance for managers launching alternative and progressive funds, where the tax treatment is often less established and more fluid. For such funds, managers' belief in the ability of a regime to offer a clear and certain approach and stable environment is of critical importance.

1.6 Luxembourg and Ireland tax regimes are viewed more favourably than the UK

Managers view the Luxembourg and Ireland tax regimes more positively than the UK regime across most fund types. As a result, for many managers, the UK is not a competitive location for domiciling funds.

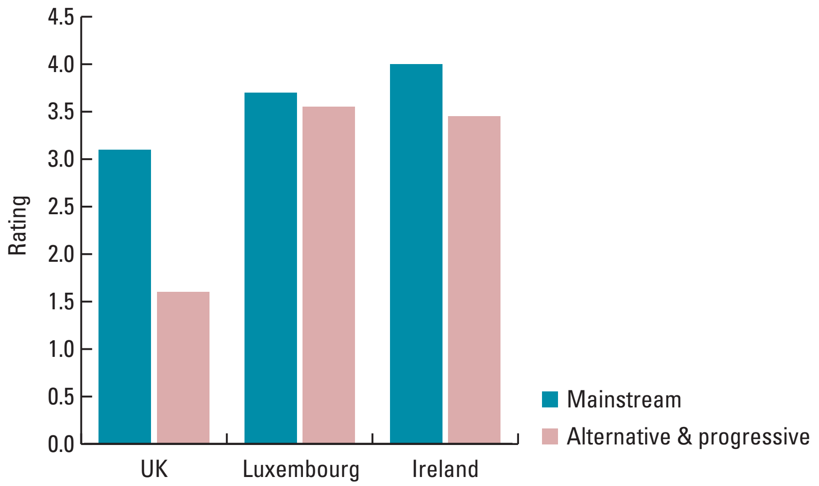
A principal weakness identified by participants in the UK tax regime is the lack of certainty, stability and support from the tax authorities. The perception is that HM Revenue and Customs (HMRC) does not understand the industry, lags behind regulatory change and focuses on anti-avoidance rather than on supporting a competitive industry. As a result, the UK tax structure is much more burdensome than elsewhere.

Even when the differences are nothing more than perception, with certain UK domiciled funds more tax efficient than exempt Luxembourg counterparts, the lack of certainty of tax treatment and constant change undermines the attraction of the UK as a fund domicile.

Going forward, as funds become more sophisticated and alternative, the differences between the UK and other domiciles will become more apparent, further weakening the UK position.

Figure 1.2 shows how participants rated the UK, Luxembourg and Ireland tax regimes.

Figure 1.2
Preferred tax regime by fund type
(On a scale of 1-5, where 1 is low and 5 is high)



Source: KPMG / IMA Survey

1.7 Fund domicile influences the location of other investment management functions

Administration functions for funds tend to follow domicile, primarily for practical operational reasons, but also due in part to regulatory requirements, which vary from location to location. Funds that are managed in the UK, but that are domiciled overseas, therefore result in a loss to the UK of the economic benefits arising from administration, employment and other indirect services (for example, provision of tax, legal, and accountancy services). This weakens both the UK investment management industry and the wider UK economy.

The situation concerns investment managers because it hinders them when pursuing their commercial objectives. Funds form an integral part of the investment management value chain and the UK savings environment, and for many managers there is commercial logic in domiciling funds in the UK. If managers believe they are forced to domicile funds offshore as a result of an unfavourable tax environment, the overall UK investment management and savings frameworks will be weakened.

The UK is still the EU location of choice for core investment management activity, but by no means should the Government be complacent that this will continue. Competition from other investment centres for the core investment management function is intensifying and the potential business efficiency of co-locating funds and investment managers cannot be disregarded. Hedge fund managers are particularly flexible in this regard, with no compelling reason to locate in any particular location, including the UK.

1.8 Recommendations

The UK funds industry is approaching a tipping point. The industry and the authorities should consider a number of options; not only to halt the decline of the UK's market position, but also to position the UK to grow its share of the EU funds market going forward.

1.8.1 Encourage improved consultation and strengthened trust between the industry, HMRC and the other regulatory authorities

The Ireland and Luxembourg authorities are generally both supportive of the industry and work together with it to deliver a coherent overall approach to industry issues. This is not the UK experience for many managers.

The UK needs to develop the same collaborative and constructive approach, recognising that this requires better engagement from both the industry and the authorities. In particular, the industry must endeavour to understand and address or challenge HMRC concerns over tax avoidance and, where necessary, offer suggestions to help HMRC meet its goals.

1.8.2 HMRC to promote a better internal understanding of the industry

An underlying industry frustration has been the belief that HMRC is neither focused on, nor sufficiently understands, the investment management industry. There should be greater focus by HMRC on investment management as a sub-set of financial services and the creation of a structure to enable this to happen.

1.8.3 Address the property fund conundrum

Industry participants are keen to provide UK domiciled open-ended property funds for a range of UK investors, but can be forced to domicile such funds offshore due to current tax rules. HMRC should work with the industry to agree and implement an appropriate tax regime for these funds.

1.8.4 Seriously consider abolition of the Stamp Duty Reserve Tax (SDRT) Schedule 19 Finance Act (FA) 1999 regime

This funds-specific SDRT regime adds complexity to the UK tax regime. It creates an additional compliance burden for managers, as well as making UK funds harder to understand and therefore less attractive to investors when marketed offshore. HMRC should consider abolishing this regime, together with introducing appropriate anti-avoidance measures. This report estimates that this regime yields the Government around £40 million per annum.

1.8.5 Allow authorised funds to trade without incurring a corporation tax charge

The UK tax regime distinguishes between trading and investment activities, subjecting the former to corporation tax at fund level. HMRC should consider removing this distinction. This could, if thought necessary, be accompanied by the introduction of a targeted anti-avoidance measure to help ensure that it would be applicable only for funds that are operated on an arm's length basis (perhaps along the lines described by the UK's investment manager exemption at section 127 FA 1995 and Schedule 26 FA 2003).

1.8.6 Pending the European Court of Justice (ECJ) decisions, consider full tax exemption at fund level

The taxation of funds was identified by survey participants as a significant negative component of the UK tax regime, and it is recognised that UK funds find it difficult to compete on equal terms with tax exempt offshore funds. However, there is no clear consensus supporting a tax exempt status for UK funds, largely due to the impact that this could have on UK funds' ability to access the benefits of tax treaties.

The outcome of current ECJ cases could significantly reduce any treaty benefits, and if this is the case, the industry should seriously consider working with HMRC to grant funds tax exempt status. This report estimates that the corporation tax yield from funds is around £85 million per annum.

Introduction

2.1 Background to this report

In 2005 the IMA and Corporation of London commissioned Oxera Consulting Limited to assess the competitive position of the UK as an investment management centre and the major influences that may affect this position in the future.

The ensuing report *'The Future of UK Asset Management: Competitive Position and Location Choice'* concluded that core investment management and marketing / distribution activities appeared to be quite securely located in the UK and that investment management firms generally expected no significant shifts of business out of the UK at least in the next few years. However, the report also found that when deciding where to set up Collective Investment Vehicles (CIVs), managers are increasingly looking offshore:

"The UK has already missed out on a considerable proportion of the market for investment funds. Even if the management of the funds remains located onshore, the development of offshore centres has employment and revenue consequences for the UK. Luxembourg and, in particular, Dublin have seen substantial growth in activities associated with the support and servicing of funds, and have developed as 'centres of excellence' in these activities. Offshore fund domicile is therefore a matter that deserves close attention by the UK authorities[3]."

The report states that taxation has had a significant influence on this decision:

"The one area in the asset management industry where the role of regulation and taxation has been significant relates to collective investment funds…Taxation and / or regulation are critical to the choice of where to domicile funds. Collective investment funds managed from the UK have increasingly been established in, or shifted to, offshore locations for these reasons[3]."

In the light of these conclusions, the IMA commissioned KPMG to analyse the tax provisions that impact the fund location decision and to consider further the extent to which fund domicile matters for the UK fund industry and wider economy.

3 Source: Page 61, Oxera, 2005

2.2 Methodology

KPMG conducted interviews with 26 investment management groups and four administration companies. A range of executives were interviewed including Chief Executive Officers, Chief Operating Officers, Heads of Product Development and Heads of Tax. In addition, KPMG conducted secondary research to challenge or to provide further support for the issues raised by the participating IMA members and affiliate members.

KPMG and IMA extend thanks to those who took part in the project. Alongside the groups mentioned in Appendix 1, a valuable contribution was also made by the Depositary and Trustee Association.

The sample of participants was selected to provide a mix of UK-centric and global businesses, comprising both stand-alone investment management groups and those with banking or insurance parents. Together, these groups manage 62.5 percent, in terms of Funds Under Management (FUM), of UK authorised funds as at 31 May 2006[4].

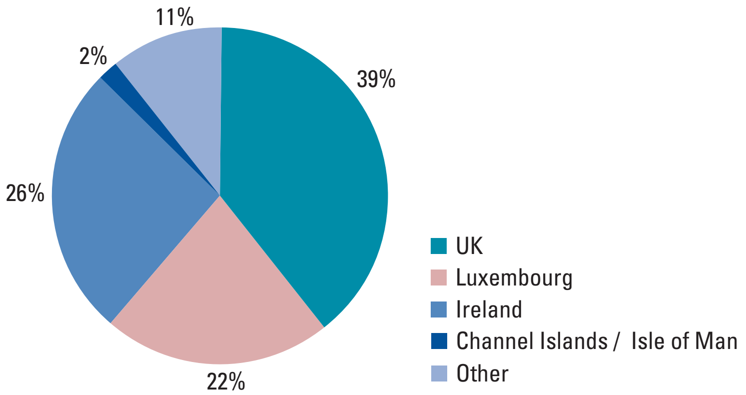
The participants' fund structures can be broadly categorised as follows, with the diversity of models leading to different responses to the questions.

- Groups with a flagship fund range domiciled in a major offshore centre (principally Luxembourg, occasionally Ireland) that is intended for cross-border sale. Parts of the range are duplicated through funds domiciled in other countries if this facilitates distribution. This is the typical model favoured by most managers, and in particular those that are part of US groups.
- Groups with a flagship fund range domiciled in the UK that is intended for cross-border sale. Managers operating this model tend to have historic ties to the UK.
- Groups with a number of fund ranges domiciled across the EU that have grown piecemeal. There is no dominant range and often ranges overlap. Such managers have often acquired ranges from other investment managers and have been unable to rationalise fund ranges for tax or regulatory reasons or because local markets prefer local funds.
- Groups with a flagship fund range domiciled in the UK and few funds elsewhere, because the target market is predominantly the UK or because the range was set up before Luxembourg had established itself as a funds centre.

4 Source: IMA monthly statistics

Figure 2.1 illustrates the domiciles where participants have located their funds by FUM. There is a UK bias compared with the European industry wide European Fund and Asset Management Association (EFAMA) statistics in Figure 3.2, which suggests that UK based managers are more focused on the UK market, and hence UK funds, than continental managers.

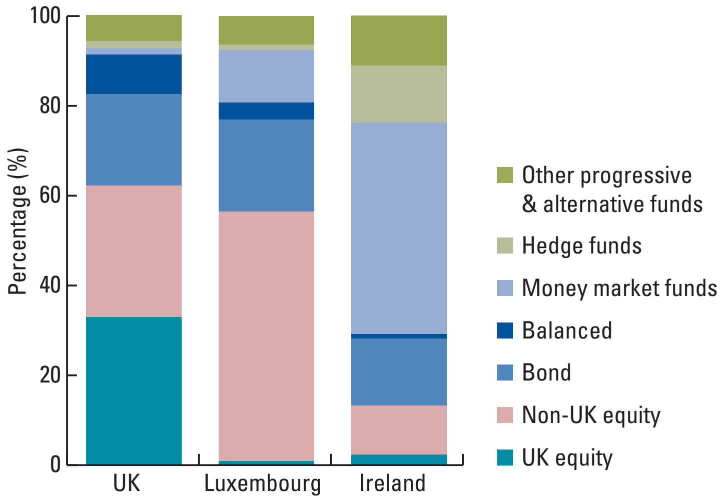
Figure 2.1
Domicile of CIVs managed from the UK (% by FUM)



Source: KPMG / IMA Survey

Figure 2.2 considers the participants' CIV assets by both domicile and asset type. The analysis is broadly in line with expectations; mainstream funds aimed at the UK market, but not progressive and alternative funds, tend to be domiciled in the UK.

Figure 2.2
CIVs managed from the UK by domicile and type (% by FUM)



Source: KPMG / IMA Survey

Figure 2.3 analyses the split between retail and institutional investors. The majority of investors in UK and Luxembourg funds are retail-focused, whereas Dublin has established itself as an attractive location for institutional funds.

Figure 2.3
CIVs by investor type

Source: KPMG / IMA Survey

2.3 Scope of the report

This report is concerned with CIVs established by UK based investment managers. The term CIV is intended to be all-encompassing and, except for insurance based products, includes all open-ended pooling arrangements, be they corporate, trust based or contractual.

Although insurance groups have made a significant contribution to this report (as major investors in collectives and owners of investment management subsidiaries), funds within insurance companies are excluded from this report because the insurance products are subject to a separate regulatory and taxation regime from other pooling arrangements.

All major asset classes have been covered with the exception of private equity. The structures used and tax issues faced by private equity houses were considered to be too specific for the scope of this report.

The main funds managed by participants and discussed in interviews are:

- Investment Companies with Variable Capital (ICVCs), i.e. open-ended corporates, including UK Open-Ended Investment Companies (OEICs) and Luxembourg Sociétés d'Investissement à Capital Variable (SICAVs).
- Unit trusts (trust based schemes that are predominantly in the UK and Ireland).
- Contractual schemes (for example, the Irish Common Contractual Fund (CCF) and Luxembourg Fonds Commun de Placement (FCP)).
- Investment trusts (closed-ended companies that are predominantly in the UK).

More detail of the fund types is included in Appendix 2.

Unless the context suggests otherwise, this report treats 'investment funds' or 'funds' as synonyms for CIVs.

2.4 Structure of the report

Chapter 3	provides background information on the investment funds industry.
Chapter 4	considers factors influencing the decision on location of fund domicile.
Chapter 5	considers specific tax factors that influence the fund domicile decision.
Chapter 6	considers the impact that the domicile decision has on the UK funds industry and the wider economy.
Chapter 7	draws conclusions and recommends actions.

Profile of the European investment funds market

3.1 Development of the market

The investment funds industry is an important part of the UK and European economy, providing significant employment in a number of locations. The industry plays a vital role in facilitating and supporting investor savings, providing the pooled vehicles that are for many investors (retail and institutional) the only way to invest in securities in a cost–effective manner.

The European investment funds industry developed on a country-by-country basis over a number of years, with the fund structure for each country reflecting the relevant domestic legal, regulatory and tax frameworks. This led to a number of different types of investment fund across the EU with correspondingly different tax and regulatory treatments.

The EU recognised the inherent inefficiency this diversity created in the pan-European market (predominantly sub-optimal fund sizes), and furthered the process to harmonise funds regulations in 1985 by issuing the UCITS Directive[5]. This Directive lays down regulation that primarily governs the underlying investments a fund may invest into with the purpose of providing a degree of investor protection. Funds that comply with the regulatory standards of the UCITS Directive are eligible to be distributed cross–border within the EU. Furthermore, UCITS–compliant funds are accepted in many global markets, particularly Asia. Within the EU, UCITS dominate the fund market, accounting for in excess of 75 percent of the value of investment funds covered by EFAMA.

Many jurisdictions, including the UK, also provide a regulatory framework for funds that have broader investment and borrowing powers than the UCITS Directive allows. The UK regulations classify two such fund types – Non-UCITS Retail Schemes (NURS) and Qualified Investor Schemes (QIS). As these funds have wider investment powers, the taxation issues can be more complex.

3.2 Current state of the market

3.2.1 Current market position

In 2003 the IMA commissioned a study on the state of the single market for asset management (Heinemann, 2003). The headlines of this report were:

- European funds are held primarily by European investors (over 75 percent).
- The US market is effectively closed to the marketing of EU based funds because of the US regulatory regime, which makes it "practically impossible" (Heinemann, 2003) for European investment management funds to meet Securities and Exchange Commission (SEC) criteria.

[5] UCITS and their managers are subject to the UCITS Directive (85/611/EEC) and two amending Directives that are together referred to as UCITS III. The level of regulatory protection provided by the Directive means that UCITS can be offered to retail investors in any Member State after authorisation in the home Member State subject to notification in each host Member State.

- There is appetite for UCITS funds in significant markets outside the EU, for example, Mexico and the Far East.
- When entering major European markets, fund promoters are often forced to establish a domestic range because of distributor bias or regulatory or tax requirements. This means that the European market is less efficient than it could be.
- Luxembourg has established itself as a centre of excellence for cross-border retail distribution. Ireland, on the back of its International Financial Services Centre, has established a strong reputation for certain types of institutional fund, for example, money market funds, and fund administration for both Irish domiciled funds and Cayman domiciled hedge funds.

These conclusions still largely hold true. The slow, but growing, erosion of national barriers and the consolidation of the European funds market into a smaller number of centres has continued, particularly in respect of fund domiciles. This has been driven both by regulatory and market forces.

"…the industry's business model is evolving with a growing number of global fund management groups operating from Luxembourg and Dublin to the detriment of their domestic markets. Based on this evolution, local managers need to sharpen the value proposition of their funds to maintain market share[6]."

Regulatory forces

The 1985 UCITS Directive provided the regulatory framework to harmonise EU markets, and has been moderately successful in opening up a cross–border market for funds in the EU. A recent EU Green Paper (EU Commission, 2005) reported that the use of UCITS product passports doubled between 2000 and 2005, with 16 percent of sales being truly cross–border (i.e. excluding round-tripping – the practice of targeting investors in the same domicile as the manager via a non-domestic fund).

However, the Green Paper also concluded that the UCITS regime had not been as successful as envisaged in creating a more efficient pan-European investment funds market; European funds remain on average five times smaller than US equivalents, reducing economies of scale and benefits to end customers. To address this situation, the EU Green Paper identified ways to build on existing legislation to progress towards a more efficient EU funds market. In doing so, it explicitly recognised the growing influence of offshore centres.

6 EFAMA Fact Book: Trends in European Investment Funds, 2005

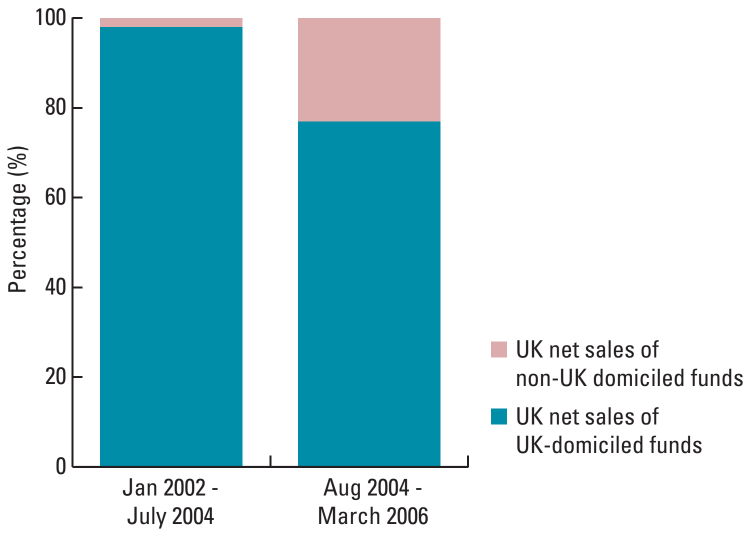
Market forces

A combination of the lowering of protection barriers for national markets and the increasingly international focus of investment managers has led to the growth of EU cross-border sales.

Although national markets have never been fully closed, the increased use of open architecture has further opened up these markets to non-domestic investment managers, allowing them to promote standardised, acceptable funds into different markets. The growing international nature of investment managers' businesses has in turn led many to increase their efficiencies through optimising fund ranges and reducing associated costs by creating a single fund range that is acceptable in many markets rather than multiple fund ranges designed for each single market. The growth of Luxembourg SICAV funds has been partly driven by this trend.

Changes to the UK's offshore funds tax legislation in 2004, which made it possible for offshore sub-funds or share classes to qualify for distributor status, accelerated this development by opening up the UK market to offshore funds. As Figure 3.1 suggests, the changes have helped enable Ireland and Luxembourg based funds to increase sales into the UK. In the 31 months to 31 July 2004, sales from Ireland and Luxembourg comprised one percent of net sales. In the 19 months to March 2006, they comprised 21 percent of net sales.

Figure 3.1
UK market – Net fund sales Jan 2002 – March 2006



Source: FERI / FMI. Data based on contribution of 27 cross-border groups, showing sales into the UK from Luxembourg and Dublin. The 27 contributors are estimated to account for around 75 percent of pan–European cross-border business.

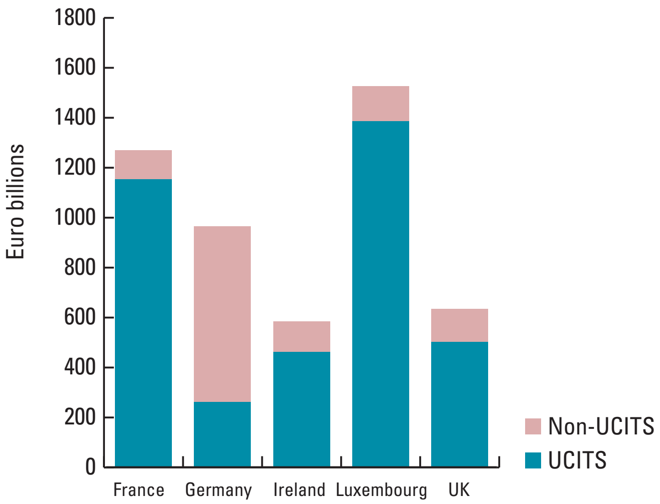
The substantial growth of offshore fund centres, particularly Ireland and Luxembourg, is evidence of the trend towards a harmonised EU market. The EU Green Paper and Commissioner McCreevy's closing remarks at an open hearing on 19 July 2006[7] provide further evidence of the political support for harmonisation of an efficient market. With such support, the continued success of existing centres will depend upon their ability to create an environment that can compete successfully with offshore jurisdictions.

"Indeed, market growth in offshore fund assets has significantly outstripped major mutual fund markets in Western Europe and the US for each of the last five years…Datamonitor anticipates that within Europe the drive to consolidate funds is likely to favour a smaller number of larger offshore centres (in particular Luxembourg and Dublin) where the supporting administration and fund servicing infrastructure is well established [8]."

3.2.2 Market statistics

Figure 3.2 shows the size of the European asset management market for CIVs, and the split between UCITS and non–UCITS funds.

Figure 3.2
Comparison of net assets of the major European markets



Source: EFAMA, Trends in the European investment funds industry in the final quarter of 2005 and results for the full year 2005 (March 2006)

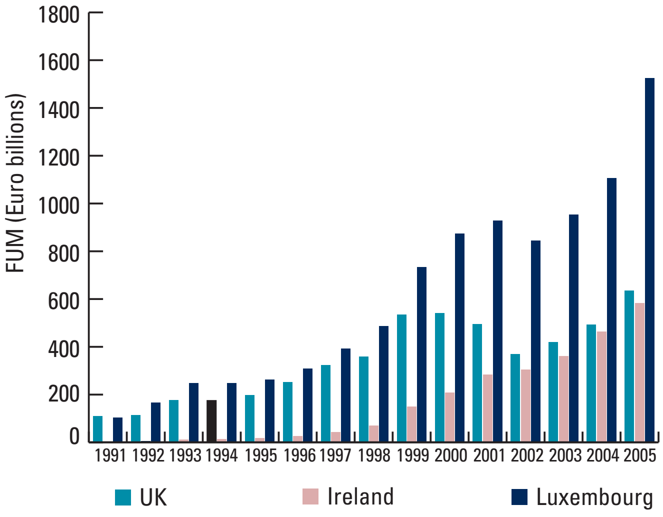
Figure 3.2 illustrates the way that Ireland and Luxembourg, both of which have small populations and a low level of domestic investment assets, have taken advantage of the UCITS regulations to establish themselves as offshore centres and grow their investment management industries. By comparison, the funds industries of France, Germany and the UK have relied on the strength of domestic demand.

7 Open Hearing on Retail Investment Funds, Market Efficiency, Hedge Funds and Private Equity Funds: http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/06/465&format=HTML&aged=0&language=EN&guiLanguage=en

8 Datamonitor, 2005

Figure 3.3 shows the growth of UK, Ireland and Luxembourg domiciled funds.

Figure 3.3
Growth in registered fund assets



Source: EFAMA / IMA

"The gap is just huge now. Had the UK acted ten or fifteen years ago the story might be different, but things have moved on so much."

"Had we set up our funds eight to ten years ago when the Luxembourg industry was small and fragmented, the UK might have featured in the decision."

Quotes from participants

In addition to the above, as at June 2005 Ireland administered a further US$327 billion of funds domiciled outside Ireland[9].

Both Ireland and Luxembourg have built critical mass over a relatively short period, to the point where they now hold leading market positions as offshore fund centres. During the same period, the growth of the UK market has been much less pronounced. Participants in our survey realistically recognise that there is little likelihood of fully reversing this situation.

Positive and active sponsorship and support by Governments has been instrumental in creating a favourable environment for the funds industry in Ireland and Luxembourg, with the Irish Government in particular being a significant factor behind the growth of the Irish market (see Appendix 3). This in turn has facilitated much of the growth for these centres and remains a continuing positive factor for these centres, in particular in the way that it encourages a joined-up approach to the industry across tax and regulatory areas.

[9] Source: Dublin Funds Industry Association (DFIA)

The fund domicile decision

4.1 Summary

This chapter considers the factors that have influenced managers' choice of fund domicile. The key findings are:

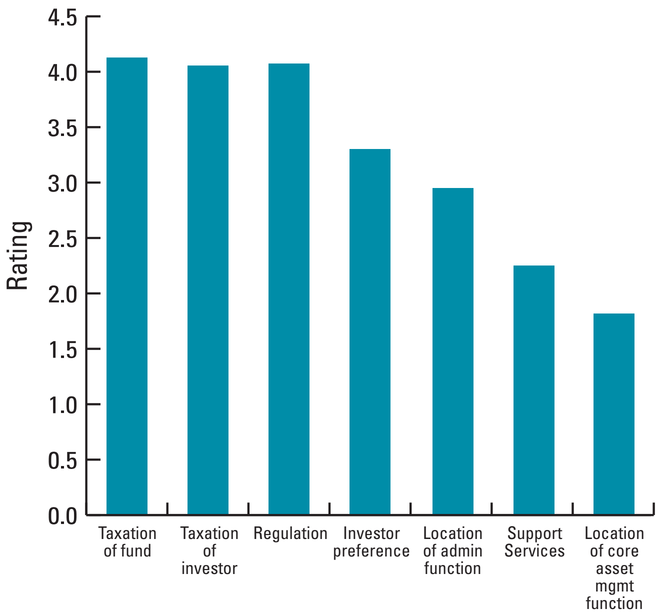
- Taxation of the fund, taxation of the investor and regulation were identified by participants as principal factors in fund domicile decisions.
- Participants consider these factors to have greater importance for alternative and progressive funds than for mainstream funds.
- Participants look for a favourable tax and regulatory regime together with a supportive approach from Government, regulatory and tax authorities when deciding upon fund domicile.

4.2 Factors influencing the fund domicile decision

Participants were asked to rank in order of importance the more common factors that influence the decision on where to domicile funds. The results are set out in Figure 4.1.

Figure 4.1
Factors influencing domicile decision (weighted average)
(On a scale of 1-5, where 1 is low and 5 is high)

Answer to the question as to what extent managers bear the following factors in mind when deciding where to locate a fund.



Source: KPMG / IMA Survey

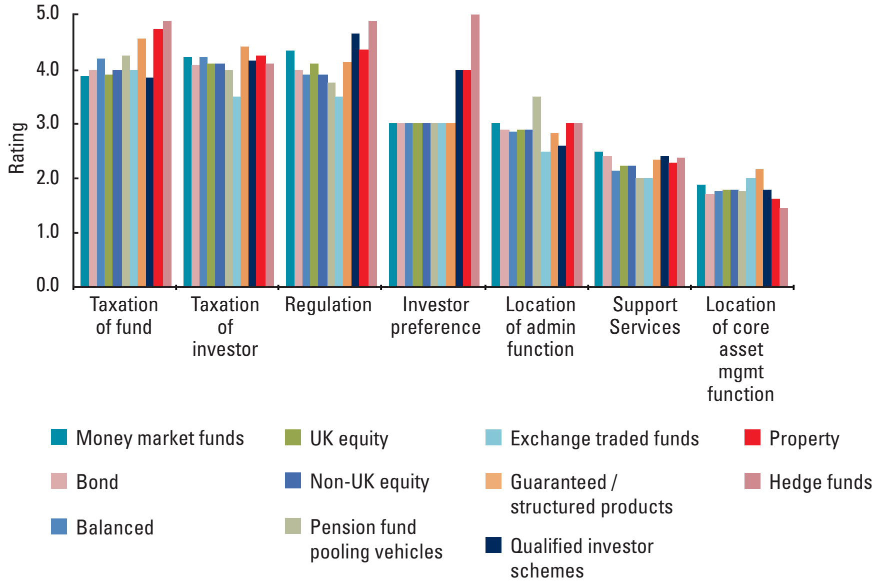
The results highlight that:

- The most important factors consistently identified by participants are taxation of the fund, taxation of the investor and regulation.
- Investor preference is also of importance to a number of participants.
- Location of the core asset management function has least impact on the fund domicile decision.

The results are consistent with the Oxera report findings, particularly the importance of tax and regulation in the domicile decision.

Further analysis of the results in Figure 4.2 shows the importance of factors by fund type, differentiating between mainstream funds (money market, bond, balanced, and UK and non–UK equity) and the more alternative and progressive fund types (Pension Fund Pooling Vehicles (PFPVs), Exchange Traded Funds (ETFs), structured / guaranteed products, QIS, property funds and hedge funds).

Figure 4.2
Factors influencing domicile decision (by fund type)
(On a scale of 1-5, where 1 is low and 5 is high)



Source: KPMG / IMA Survey

The results show that virtually all factors have a greater significance for alternative and progressive fund types. They also highlight that, for alternative and progressive funds, investor preference is a key factor alongside tax and regulation, although this can be closely attributed to the overall appeal and environment of a domicile, including the attitude of authorities, and specific tax and regulatory issues.

In addition, the results suggest that EU member states wishing to retain and attract general funds business must establish appropriate tax and regulatory regimes that are supportive of the industry. This requirement is greater for alternative and progressive fund types, where investor preference for the overall environment of the domicile is also a key factor. With strong predicted growth in the alternative market and as yet no clear domicile of choice for these funds within the EU, opportunities still exist for member states to secure the economic benefits from becoming the domicile of choice for these funds.

"Over 60 percent of fund managers believed that alternative investments (defined as hedge funds, property, private equity and capital protected / structured products) would become as important as traditional investments in their jurisdiction in the next two years[10]."

[10] Source: Datamonitor Offshore Fund Management Survey 2005, page 8

4.3 Explanation of key factors

In addition to the factors presented in the questionnaire, participants identified a wide range of other characteristics they look for in a location when selecting fund domicile. While these covered specific commercial and tax / regulatory areas, the underlying common theme was the ability of the domicile to support participants' business objectives.

The characteristics consistently identified were:

- A generally welcoming and stable political environment with a constructive approach from Government, regulators and tax authorities.
- A supportive tax and regulatory regime to enable the fund to operate in the most effective and efficient manner.
- Acceptability of the fund type to investors and distributors.
- Ease of process with regard to new fund launches.
- Maximisation of efficiency and economies of scale.
- A favourable business environment with established infrastructure.

These are explained further as follows.

A generally welcoming and stable political environment provides the business conditions to support the investment management industry. This extends beyond rules and regulations to reflect the approach and attitude of the tax and regulatory authorities, in particular a willingness by authorities to work positively and constructively with the industry in developing new products and in encouraging innovation. The collaborative approach of both Luxembourg and Ireland was also cited by many participants, in particular the way in which regulatory and tax authorities strive to operate in a joined–up manner to deliver a holistic approach to the industry.

A supportive tax and regulatory regime enables the manager to operate the fund in the most effective and efficient manner. Differences in tax and regulation exist between jurisdictions, and can become significant drivers of fund domicile location (for example, money market funds in Ireland). Even when the differences are not material enough to override other location deciders, perceived and / or historic views of the regimes can still influence the domicile decision. A number of participants believe that the tax exempt treatment for Luxembourg domiciled funds has a greater perceived impact in the eyes of investors and distributors than its actual impact, in essence being an easier 'sell'.

The acceptability of the fund type to investors and distributors reflects managers' ability to promote funds and generate sales. Participants believe that investors prefer funds that are domiciled either in their own country or in a recognised offshore location. This applies both to the retail market, where Luxembourg is increasingly viewed as the default domicile of choice, and to alternative funds, where there exist favoured locations for certain asset and fund types (for example, Cayman for hedge funds). For the same reason, distributors will prefer to promote funds that are acceptable to investors and therefore easier to sell; many managers regard time spent explaining the location decision to investors and distributors as time wasted.

"We're not yet at the tipping point, but the tipping point will be with us within the next five years – UK investors are no longer suspicious of offshore funds."

Quote from participant

For many countries, including the UK, this has long supported a home market bias. One participant stated that creating a French fund was essential for non-French firms entering that market, a view supported by the fact that in 2002 foreign funds held less than four percent of the French market [11].

However, within the UK, there are signs that the home bias is changing, with UCITS-branded European domiciled funds (particularly Luxembourg SICAVs) increasingly being sold into the UK (see Figure 3.1). The IMA's decision in May 2006 to collect with a view to publishing offshore fund sales statistics, together with the growth of platforms that distinguish less between fund types, is encouraging this trend. The corresponding sale of UK funds into Europe is less evident.

Ease of process recognises the need for speed to market. Participants stated that they often return to familiar locations to set up new funds where they believe the process is straightforward and works. Similarly, participants indicated that, when setting up that product for the first time (for example, hedge funds), they will select a domicile with a proven track record in the product type since the required expertise and infrastructure will be in place.

Maximisation of efficiency and economies of scale enables managers to generate better returns. Principal ways to achieve this include minimising the duplication of funds and operating from fewer locations, although there was no consistent view from participants on the optimal number of domiciles. Some stated a desire to move to a single range of funds in the future, while others believe they can achieve sufficient scale to support fund ranges in each major market. Most participants continue to maintain a watching brief on regulatory and market developments to identify future efficiency opportunities[12].

A consistent message from participants was the difficulty in moving funds established in one domicile to another. Significant regulatory and other barriers (for example, the agreement of all shareholders is required to migrate a fund from Luxembourg) mean that in practice, a location, once selected, is fixed. This underlined the care taken by managers in selecting a domicile for the long term, and the reluctance by many managers to expand operations into multiple locations. Only a few participants cited examples of trying to move fund domicile.

A favourable business environment with established infrastructure is effectively a hygiene factor for managers. They expect all major centres to contain the skilled people, professional services and other functions necessary to support investment management needs. This is more of a factor for managers that are looking at new domicile options (for example, for new alternative products), although such is the expansion of Luxembourg and Dublin that concerns were raised over whether these centres could continue to support future business growth given capacity constraints.

[11] Heinemann, 2003
[12] For a detailed discussion of the merits of mergers and pooling, see the IMA's 'Pooling: How can fund managers respond to different needs', July 2005

Fund taxation issues

5.1 Summary

This chapter considers the competitiveness and details of the UK tax regime. The key findings from participants are:

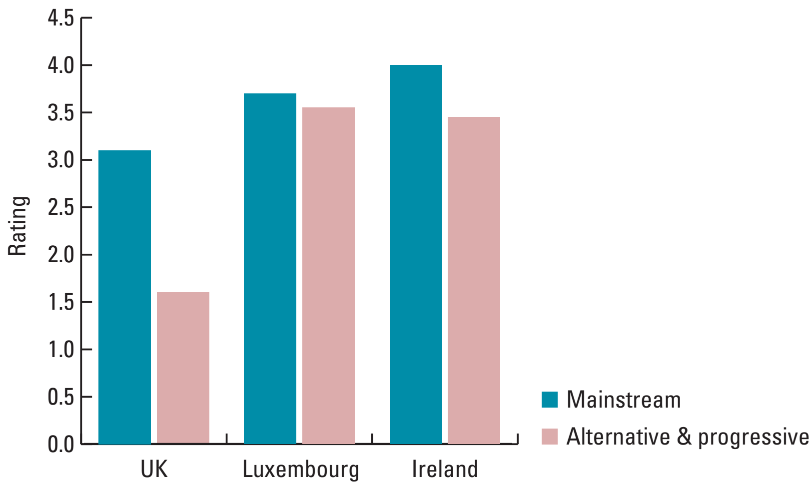
- The tax regimes of Luxembourg and Ireland are favoured over that of the UK for almost all fund types.
- The UK regime for alternative and progressive fund types (for example, hedge funds, property funds and QIS) is viewed particularly poorly when compared to Luxembourg and Ireland.
- The tax authorities' attitude and the overall lack of stability and certainty of the UK regime are considered to have a significant influence on the decision of participants to locate funds outside the UK.
- The main specific tax reasons for locating funds outside the UK are direct tax at fund level (particularly for hedge funds and property funds) and SDRT.
- Withholding tax and access to tax treaties are the only areas of the UK regime viewed favourably by participants.
- While participants broadly agree on the uncompetitive aspects of the UK regime, there is less agreement on the ideal UK tax regime for CIVs.

5.2 Rating of tax regimes

Participants were asked to consider the position of the UK tax regime compared to Luxembourg and Ireland for different types of funds. The results are shown in Figure 5.1.

Figure 5.1
Preferred tax regime by fund type
(On a scale of 1-5, where 1 is low and 5 is high)

Where taxation has affected your decision, how well do the following jurisdictions score?



Source: KPMG / IMA Survey

For all fund types, the UK tax regime is viewed less favourably than those of Ireland and Luxembourg, with the difference between the regimes being greater for progressive or alternative funds than for mainstream funds. As these are the major industry growth areas where the domicile of choice within the EU has yet to be firmly established, the prospect for the UK becoming the domicile for these funds under the current tax regime appears remote.

5.3 Detailed comparison of tax regimes

Some of the taxation factors that led to these differences are described as follows, with a further high-level comparison of the UK, Ireland and Luxembourg tax regimes set out in Appendix 4.

5.3.1 Mainstream funds

For the purpose of this section, this category comprises money market, bond, balanced, and equity (UK and non-UK) funds.

Given that there can be little to choose between the UK, Ireland and Luxembourg tax regimes, in terms of their practical effect, when analysing the tax efficiency of mainstream funds (except for balanced funds), it is surprising that the UK scores relatively poorly. This would indicate that other negative factors highlighted by participants influence their views on the UK tax regime to a greater extent than the underlying detailed tax provisions, in particular the tax authorities' attitude and the uncertainty / instability of the UK tax regime (see Figure 5.2).

A technical analysis of the tax treatment for the mainstream funds is set out as follows.

Money market

Historically, the UK tax regime was less advantageous than Ireland and Luxembourg, primarily due to funds making net rather than gross distribution payments. However, as a result of the UK allowing gross payment of interest distributions to most types of institutional investor, and Luxembourg reducing the rate of 'tax d'abonnement' (an asset based tax), there is now little real tax difference between the three locations in respect of pure money market funds. However, a legacy of negative perceptions remains.

Significant regulatory (as opposed to tax) differences do exist for liquid asset / near cash funds that contain tradable instruments as opposed to pure cash deposits. The UK requirement to account separately for capital and income means that unrealised market movements cannot be distributed. In contrast, Ireland and Luxembourg funds are able to distribute such gains, thereby maintaining a constant share price. By doing so, Ireland and Luxembourg funds are able to compete more successfully against bank deposit accounts on a like for like basis. This disadvantage could be eliminated by allowing UK funds to set up a more flexible distribution policy in their prospectus.

Bond funds

As with money market funds, fixed income funds are able to pay gross interest distributions and hence the UK tax treatment is competitive subject to concerns over the UK administrative procedures required to secure gross payment.

Balanced

The UK's taxation of funds and its distinction between bond funds and other funds renders it an inefficient domicile for balanced funds. Only funds that continually invest more than 60 percent of assets in bonds and other debt-like securities are able to treat distributions as tax deductible interest payments. For funds that do not meet this criterion, distributions are treated as dividends and are therefore not tax deductible, irrespective of the value of bond assets held. As a result, UK funds are typically heavily weighted in either bonds or equities rather than being balanced. Funds in Ireland and Luxembourg, which are exempt from tax, do not face this issue.

Government proposals to replace the '60 percent test' with more precise streaming of income were withdrawn after the industry argued that the cost and complexity of a more sophisticated regime would outweigh the benefits of allowing balanced funds to be truly tax efficient.

UK equity

The UK tax regime has positive aspects for UK equity funds, and is broadly considered by participants to be on a par with those aspects of the Ireland and Luxembourg regimes.

The UK does not withhold tax on dividends and UK funds are not subject to tax in respect of dividends received from UK companies. In practice, therefore, the funds do not suffer direct tax.

Furthermore, UK resident investors receive favourable treatment on dividends when compared to dividends from Ireland and Luxembourg domiciled funds. Dividends from UK funds carry a 10 percent notional tax credit meaning that higher rate taxpayers pay tax at 25 percent with reference to the net dividend, and basic rate taxpayers have no further liability. By contrast, dividends from Ireland and Luxembourg funds are subject to tax at 32.5 percent (higher rate) or 10 percent (basic rate). This 10 percent charge can be burdensome if the taxpayer has no other reason to file a tax return. It remains to be seen whether this distinction between UK and non-UK dividends can be sustained in the light of current ECJ developments (see Section 5.6).

However, this advantage is reduced by the impact of SDRT. UK equity funds domiciled in the UK are subject to SDRT through both the charge in relation to transfers of units in the fund, as well as the charge for purchases of the underlying UK equities. Offshore funds, however, suffer SDRT only from the purchase of the underlying UK equities.

Non-UK equity

The UK tax treatment for non–UK equity funds is the only area where the UK tax regime is viewed more favourably than the equivalent regimes for Luxembourg and Ireland. This is due to the availability of the UK's double tax treaty network. Such treaty benefits are not as readily available in Luxembourg and Ireland as funds are not subject to tax in these jurisdictions. Current cases before the ECJ could reduce this advantage (see Section 5.6).

5.3.2 Alternative and progressive funds

For the purpose of this report, this category comprises PFPVs, ETFs, structured / guaranteed products, professional investor funds, property funds, and hedge funds.

Participants rate the UK tax regime far less favourably than those of Luxembourg and Ireland for these products. This is due to both distinct tax differences between the regimes as well as the overriding negative opinion that participants have of the UK tax authorities and regime.

A technical analysis of the tax treatment for the alternative funds is set out as follows.

Pension fund pooling vehicles (PFPVs)

The UK tax regime for PFPVs is not viewed favourably in comparison with Ireland and Luxembourg. The success of a PFPV depends on its tax transparency, which is to help ensure that pension fund investors suffer from withholding tax at rates no worse than they would suffer if investing directly. The analysis is important not only in the jurisdiction where the fund is, but in each country of investment and investor. For example, only if a UK pension fund holds an interest in a Luxembourg FCP that invests in US equities, can it access the beneficial tax treaty rate (zero percent rather than 15 percent or 30 percent) if the FCP is regarded as transparent by the Luxembourg, UK and US tax authorities.

Pooling vehicles in Ireland and Luxembourg (respectively the CCF and FCP) are tax transparent and thereby fulfil this key requirement. In contrast, the UK operates the Pension Fund Pooling Scheme (PFPS), a type of unit trust that is only deemed to be transparent and is further hampered by onerous reporting requirements. Other vehicles exist in the UK (for example, the Unauthorised Unit Trust (UUT)), but these offer bespoke solutions for UK pension funds and do not have global appeal.

Some regard pooling as a significant area of future development and consider that benefits will flow to the jurisdiction that best solves the associated regulatory and tax difficulties[13].

Exchange traded funds (ETFs)

ETFs are an efficient and flexible alternative to tracker funds. Ireland and Luxembourg are the favoured locations for the ETF market and none of the participants has established an ETF in the UK.

Although there are other reasons why this is the case (for example, the desirability of having the ETFs in the same location as that of the providers' main fund range), stamp duty precludes managers from domiciling an ETF in the UK. It is a selling feature of ETFs that shares traded on the secondary market are not subject to stamp duty, which they would be were the ETF itself incorporated in the UK[14]. In addition, a Schedule 19 SDRT charge would arise on redemption of units (see Section 5.5.3 for an explanation of this UK fund-specific SDRT charge).

Structured / guaranteed products

The negative perception of the UK tax regime is driven more by uncertainty than by any specific factor. The tax treatment of returns from derivatives depends on the accounting split between income and capital. This requires judgement and consideration of the motives of the investment manager. The general view of participants is that the rules are 'muddy' but, for the time being, workable.

A greater concern is HMRC's perceived mistrust of managers' use of derivatives in the light of wider powers now available under the COLL Sourcebook. Participants stated that comments in a 2004 discussion paper (HMRC, 2004) had a particularly unsettling effect. A key feature of these products is that promoters must be as certain as possible of the tax analysis for investors over a period of five years and more, and hence the uncertainty of the UK regime in this area makes the UK an unsuitable domicile location. Accordingly, most firms look immediately overseas when establishing these products.

[13] See the IMA's 'Pooling: How can fund managers respond to different needs', July 2005

[14] http://www.londonstockexchange.com/NR/rdonlyres/28FEDE11-07DE-48AF-BAC4-BCB8FED4826D/0/exchange_traded_fundsfinalpdf.pdf

Professional investor funds

A number of participants commented that the decision by HMRC to target (and directly) tax investors who hold more than 10 percent interest in a QIS has effectively ruled out the UK as an effective domicile location for these vehicles. By June 2006 KPMG was aware of fewer than 10 having been set up in the UK.

Property

The UK scores less favourably than Ireland and Luxembourg, predominantly due to the risk that UK corporation tax could be suffered at fund level, whereas Ireland and Luxembourg funds are exempt from corporation tax. Participants sense growing demand in the UK for open-ended property vehicles, but authorised funds are not efficient for those investors who pay tax at a rate lower than 20 percent (e.g. pension funds and non-resident investors).

The design of the UK Real Estate Investment Trust (REIT) regime, with its own version of the 10 percent rule, suggests that HMRC is concerned about tax leakage (HM Treasury, 2005). If UK sourced property income is converted into dividend income in the hands of non-resident companies holding more than 10 percent of a fund, and no tax is suffered at fund level, tax treaties would enable some non-resident companies to reduce withholding tax rates from 22 percent (the rate that would apply to a direct holding) to lower rates and in some cases to zero.

Currently, managers are meeting UK consumer demand through property unit trusts set up in the Channel Islands, which have become a centre of excellence for these products. A number of participants stated that tax was the primary reason for locating these funds outside the UK.

As with QIS, it is doubtful whether managers of open-ended vehicles can work around the REIT version of the 10 percent rule as they are often unaware of the identity of the ultimate beneficial owners of their funds. Given concerns over tax leakage, this is a difficult issue, but one which managers want resolved.

Hedge funds

Participants view the UK tax regime for hedge funds least favourably when compared to Ireland and Luxembourg. All managers who gave a reason cited concerns over the UK tax regime's insistence on distinguishing between trading and investment activity. UK based funds that are regarded as trading are subject to tax on total return, i.e. both income and capital gains, and therefore investors suffer more than one level of tax charge. The trading versus investment divide exemplifies two of the major concerns expressed by the interviewees, namely tax at the fund level and uncertainty[15].

[15] See *'The Revenue rears its ugly head'*, Investment Week,14 August 2006 (http://www.investmentweek.co.uk/public/showPage.html?page=341164)

The question of whether a fund is trading is far from clear. Each transaction must be assessed on its own merits with reference to established case law, which does not readily fit the modern financial services industry. As hedge fund managers conduct a variety of strategies other than long-only investment, the UK tax analysis would be complex. Managers therefore avoid the UK altogether as a domicile for hedge funds since no such concerns exist in Cayman, Luxembourg or Ireland where funds have tax exempt status.

The Financial Services Authority (FSA) will consult on the introduction of funds of unregulated schemes in the first quarter of 2007, and so the tax treatment of UK based funds of hedge funds (if not hedge funds) is likely to come under close scrutiny. This is the next opportunity for the industry, FSA and HMRC to demonstrate a joined–up approach in developing an environment that can support establishing and maintaining products in the UK market.

5.3.3 Investment trusts

Similar issues facing UK based authorised funds are being faced by investment trusts. As investment strategies evolve and the level of complexity increases, the UK tax framework for these companies appears ever more outdated and uncompetitive.

"Growth in the UK listed investment company sector has come largely from offshore domiciled investment companies in recent years."

Quote from participant

Three participants have recently established investment trusts offshore that they initially wished to establish in the UK. The main driver for this was the need to comply with section 842 Income and Corporation Taxes Act (ICTA) 1988, the criteria that an investment trust must meet to secure exemption from tax on chargeable gains. In particular, the 'investment restriction' and 'eligible investment income' tests were not designed with derivatives in mind.

Some promoters find it simpler to establish such closed-ended vehicles in a tax exempt environment. Arguably, the decision by the Association of Investment Trust Companies (AITC) to change its name to the Association of Investment Companies or 'AIC', announced on 25 April 2006, is symptomatic of this trend[16].

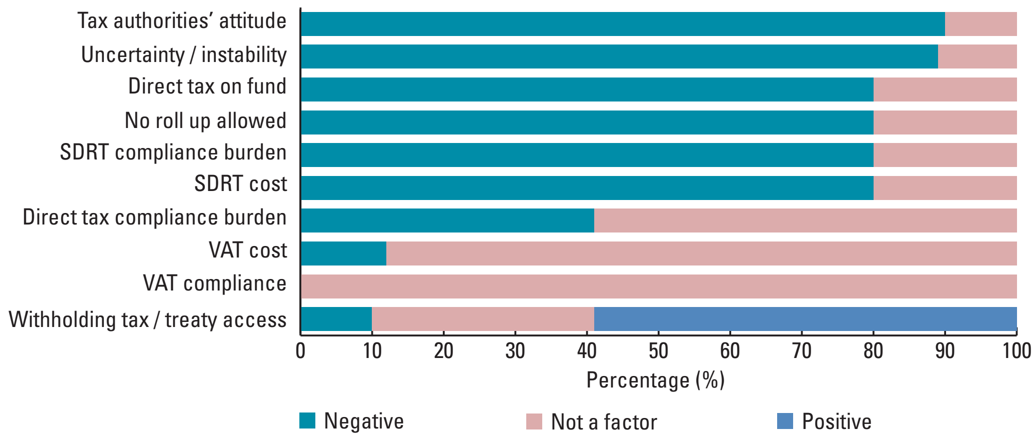
[16] AITC Press Release, AITC ANNOUNCES NAME CHANGE: REFLECTS EVOLVING INVESTMENT COMPANY UNIVERSE, http://www.aitc.co.uk/press_centre/default.asp?id=5129

5.4 Evaluation of the UK funds tax regime

Participants were asked to evaluate various aspects of the UK regime and the extent to which they influenced a decision to locate funds outside the UK. The results are shown in Figure 5.2.

Figure 5.2
Influence of specific tax factors on domicile decision

When taxation has affected your decision to locate a vehicle outside the UK, which particular aspects of the UK regime affected the decision (i.e. is the factor positive or negative from a UK taxpayer's perspective)?



Source: KPMG / IMA Survey

Participants have a predominantly negative attitude towards the UK tax regime. The only area where the regime was viewed positively was in respect of access to international tax treaties. This is a consequence of the direct taxation of funds and, as such, any benefits should be weighed against the costs resulting from direct taxation, comprising both the actual financial costs and the perception that fund taxation has among investors, particularly when compared to tax exempt funds from Luxembourg and Ireland.

An aspect highlighted by the results of the survey, but on which there was less agreement during the interviews, was gross roll up, being the ability of a fund to roll up income without crystallising a tax charge in the hands of the investor until the investor disposes of their holding in the fund. While Luxembourg and Irish funds have this capability, UK funds must show all income as available for distribution before it is paid out, reinvested or accumulated.

The lack of this provision was an unfavourable aspect of the UK tax regime highlighted by participants in the questionnaires. However, when interviewed, participants gave more ambivalent answers.

The lack of firm views suggests that, from a practical perspective, few managers had yet to find this a major barrier to selling UK funds in Europe, although this perhaps reflected little current penetration of UK funds into the Southern European countries (Spain, Italy and Portugal) where this policy is of particular importance.

5.5 Key areas to change in the UK tax regime

During interviews, participants were asked to list the aspects of the UK tax regime that concerned them the most and which they would like to see changed. The main issues raised were:

- A lack of confidence and trust in the UK tax regime.
- Tax at fund level (particularly for trading and property funds).
- SDRT at fund level (the Schedule 19 charge).
- Overall complexity.

These were consistent with the key unfavourable elements of the UK tax regime that participants identified through the survey (see Figure 5.2).

5.5.1 A lack of confidence and trust in the UK tax regime

The most common concern with the UK tax regime is not a specific tax measure that can be fixed by a change in legislation. Rather, it is the overall management of the UK tax regime, characterised by:

- The pace of change and the style of consultation.
- The overriding attitude of HRMC.

The majority of participants want HMRC to work constructively with the industry in developing the environment to support the investment funds industry.

5.5.1.1 The pace of change and style of consultation

The majority of participants made strong calls for certainty and stability, regarding the lack of these as a key adverse factor of the UK tax regime.

Participants do recognise that certainty and stability are difficult attributes to build into a tax system which must be able to respond to external changes; as one participant stated, *"An unstable but effective regime is surely preferable to a stable but poor regime."* However, they object to the way in which these changes are determined and introduced. In particular, the lack of constructive consultation has led to an increasing number of surprising changes to the regulations and a number of proposed changes that were reversed after further prolonged consultation. For many participants, this equates to a lack of confidence and trust in the UK tax system and an uncertain policy making process.

"What we need is five years of [tax] stability before the UK can enter the race again."

"Overall we view the UK as an unstable regime."

Quotes from participants

Examples of recent changes or proposed changes that have contributed to this erosion of confidence include:

- *HMRC's response to the COLL Sourcebook (HMRC, 2004)*

In June 2003 the FSA published CP 185[17] that presaged the arrival of the COLL Sourcebook in April 2004 and the introduction of NURS and QIS. Although HMRC was involved from an early stage, HMRC's consultation on the measures did not appear until over a year later in July 2004, and despite much consultation with the industry, the contents of the paper took many by surprise.

Comments on derivatives caused uncertainty by questioning the appropriateness of an accounts based regime that was introduced just two years before, and the suggestion that QIS would not benefit from the established regime for authorised funds, significantly slowed development of UK based QIS.

As one participant commented: *"By this stage Ireland and Guernsey were laughing."*

- *Budget 2005 – Streaming rules and the 10 percent test*

After considering responses to its discussion paper, HMRC proposed *inter alia* introducing more sophisticated streaming for authorised funds, enabling managers to pay interest to non-taxpayers without deducting tax and a 10 percent rule for QIS.

The streaming proposals were withdrawn after protest from industry that the benefit of doing away with the 60 percent test (see Section 5.2) would be outweighed by the cost of systems changes and increased complexity involved in more precise calculations.

The 10 percent rule that targets investors in QIS holding a greater than 10 percent interest continues to thwart the development of UK based QIS.

- *VAT – The threat to deny UK managers recoverability of input tax in respect of management of offshore funds*

Alongside publication of Statutory Instrument 2003/1569, which made clear, following developments in the courts, that management of authorised funds remains an exempt supply, even if use is made of third party managers, there was a real threat that HMRC would seek to extend the exemption to deny managers input tax recovery in respect of the management of offshore funds. After intense lobbying by the industry, a Business Brief confirmed that, on reflection, there would be no change of policy in this area.

[17] http://www.fsa.gov.uk/pubs/cp/cp185.pdf

5.5.1.2 The overriding approach of HMRC

There is also a view among participants that HMRC is focused on targeting avoidance rather than creating an environment to support industry development and growth. The following note that accompanied the 2005 Budget is the type of announcement that for many participants typifies this belief:

" As access to a QIS can be limited, this flexibility offers greater scope for potential exploitation of the AIF tax regime. To counter this, the Finance Bill will include a power to make regulations to tax unit / shareholders differently if they own a substantial portion of a QIS. We will also consider the case for a purposive anti-avoidance test for QIS. For other investment funds, work will continue on the suitability of either a purposive test or other potential measures[18]."

Certain participants were disappointed by HMRC's apparent working assumption that a beneficial regime for authorised funds would be abused. For many this reflected a combative attitude rather than the constructive approach evidenced in other locations, and was further evidence that the focus was weighed too heavily towards preserving tax receipts rather than supporting the industry.

" The UK tax system undergoes constant change, or threat thereof, which results in ongoing uncertainty as to the tax treatment of funds and investors on assets totalling many billions. The UK Revenue can overturn arrangements without consultation albeit of very many years standing and is not seen to be working with the industry for the benefit of UK Plc, quite the reverse. This approach is very much at odds with that in other territories." Quote from participant.

Participants also claimed that HMRC does not sufficiently understand the industry:

" They [HMRC] do not want to understand the funds industry; they're too ready to introduce legislation to counter perceived threats." Quote from participant.

The emphasis of HMRC's recently reorganised Large Business Service illustrates that investment management is not given sufficient focus; financial services comprises insurance, banking and property[19]. By contrast, the EU Commission has set up a dedicated asset management department and the Committee of European Securities Regulators (CESR) has established an investment management working group, in parallel with banking and insurance groups, tasked with prioritising industry concerns and drawing up recommendations[20].

18 REV BN07: Reform of taxation of collective investment schemes, 16 March 2005
19 See Large Business Service Sector Leader List, May 2006, (http://www.hmrc.gov.uk/lbo/sector-leader.pdf)
20 http://www.cesr-eu.org/index.php?page=groups&mac=0&id=28

Participants were quick to draw a further comparison between the approach of HMRC and that of the FSA. The FSA was not praised by all participants, with some frustrated by the level of prescription compared with the approach taken by Luxembourg and Ireland, but many said that the COLL Sourcebook offers product developers exciting new opportunities and that the FSA should be congratulated for its business focus. They argue that HMRC concerns with avoidance (as illustrated earlier) are out of line with this progressive approach from the FSA.

A small minority of participants did not agree with these views and cited positive examples of the UK authorities, stating that they are open and willing to listen. The following are concrete examples they identified of how the Government has helped the industry in recent years:

- Two retail-focused participants argued that the ISA regime offers real tax incentives, and drives investor sales far more than any changes to the UK tax regime for funds.
- Some participants praised the Government's simplification of the pension regime suggesting that this should serve as a precedent or model for future reform of medium term savings.
- In recent years the ability of UK funds to pay interest distributions to a growing number of investors without deducting withholding tax[21] has had a significant impact, and contributed to the decision of one house to relocate funds from Ireland to the UK.
- On 16 October 2002 HM Treasury (HMT) announced a 'Boost for OEICs and AUTs'[22], a package of three measures designed to make UK funds more competitive.

The last example was accompanied by the following press release:

" These measures are an important contribution to our ongoing assault on red tape and our support for the City as a major financial centre both within the EU single market and globally[23]."

However, for many participants the impact of these positive changes was outweighed by the overall approach. In particular, the delay in implementing positive changes meant that for some managers, the decision to locate a fund outside the UK had already been taken prior to such positive changes coming into force.

21 Changes made by Finance Act 2002 enabled gross payment to pension funds and PEP / ISA holders. By contrast, the extension by Finance (No. 2) Act 2005 of gross payment to UK resident non-taxpayers has not been popular because of the operational challenges associated with paying gross to such a small sub-set of the total investor base.

22 Treasury Press Release 105/02. The three measures were:
- The process of paying interest distributions to non-UK investors was updated to take account of modern distribution channels.
- Inheritance tax legislation was changed so that non-UK domiciled investors were no longer subject to UK inheritance tax on death (this was a prime example of how perceived tax barriers turned away investors – perceived because few investors would breach the £55,000 threshold and HMRC had great difficulty in tracing those who had breached).
- SDRT merger relief was extended indefinitely.

23 Treasury Press Release 105/02

5.5.2 Tax at fund level

The fundamental difference between the UK and the Ireland and Luxembourg tax regimes is that UK domiciled funds are subject to UK corporation tax. In Luxembourg and Ireland they are exempt from corporation tax. This tax threat is detrimental to investors who expect CIVs to be tax neutral (i.e. broadly equivalent to holding the underlying investments directly).

In practice, the risk of a UK corporation tax charge is remote – UK equity funds do not suffer tax on UK dividends received and bond funds are able to claim a deduction for distributions. Furthermore, UK domiciled funds investing in non–UK equities can claim double tax relief for overseas withholding tax, which reduces their UK corporation tax liability. Our estimates suggest that the overall level of UK corporation tax paid is in the region of £85 million per year (see Section 6.4.1).

However, as past experience with inheritance tax showed, the perceived risk of a tax charge is often sufficient reason to cause overseas residents to avoid UK funds, particularly as managers market SICAV funds as exempt from tax (notwithstanding that the funds may still suffer withholding tax).

As stated previously, one of the key factors which managers look for when establishing a fund is acceptability to distributors and investors. Exemption is a simpler concept for investors to understand than the intricacies of the UK tax regime, and for many having to explain the UK tax regime to distributors and investors requires too much effort. In such a climate it is unsurprising that few managers choose to distribute UK domiciled funds into Europe, despite the fact that some UK based funds (for example, some US equity funds) have a real tax advantage over counterparts in Ireland and Luxembourg. In the words of one manager:

" Arguably, Betamax videos were a better product than VHS, but VHS won the day."

5.5.3 SDRT at fund level (the Schedule 19 charge[24])

This charge is unique to the UK tax regime. Its aim is to capture SDRT on the transfer of units from one investor to another by the fund manager. The Schedule 19 charge is calculated with reference to redemptions of fund units that are matched by new issues over a rolling two week period and the extent to which the fund invests in UK equities. It is not as visible as direct tax at fund level and our estimates suggest that it costs funds £40 million a year (see Section 6.4.1). However, it is a further complex feature of UK funds and is an additional barrier when selling UK funds abroad.

[24] The regime was introduced by Schedule 19 FA 1999

Managers regard the tax as irksome, mainly because of the compliance burden rather than the level of tax paid. The regime is complex and a monthly return must be filed that requires the input of both fund accountants and transfer agents.

Arguably, the most harmful aspect of the Schedule 19 charge and the wider SDRT regime is how they can obstruct reorganisations of both UK and non-UK funds to the extent that they invest in UK equities. Moving UK equities into or between funds as part of a reorganisation can trigger a charge. One group operates a number of segregated mandates, which it would rather combine with an existing range of UK OEICs, but the potential SDRT charge means that this commercially beneficial reorganisation cannot take place. This is harmful, because across Europe there are strong commercial reasons to reorganise and rationalise fund ranges. As the EU Green Paper (EU, 2005) states:

"Viewed from the perspective of overall market efficiency, the sector's potential is not yet fully exploited. The landscape remains dominated by funds of sub-optimal size."

5.5.4 Complexity

A feature of the UK funds tax regime that increases complexity is the need to separate income and capital. The complication caused by the need to separate income and capital is increasing in significance as the industry moves into more alternative and complex products. This means that the accounting distinction is becoming increasingly blurred. In the words of one participant:

"UK funds are awkward animals."

This is a result of the UK regulatory as well as tax regime. One administrator provided figures to show that every UK fund requires 0.66 administrators, every Luxembourg fund 0.42 and every Irish fund 0.27. It appears that the UK is more concerned with detail than other regimes; to those overseas, equalisation, the dilution levy and accumulation shares are curiosities.

5.6 Characteristics of an ideal UK tax regime

All participants agreed on the broad characteristics of the ideal regime – it should be simple, clear and certain. The tax authorities should be supportive of the UK funds industry, working with the industry to create a competitive and efficient environment to support long term growth and success.

Participants also recognised that there was limited opportunity to attract a significant number of funds back from Ireland and Luxembourg. Instead, the focus should be on getting the regime working for the future, in particular developing the regime to allow the UK to be competitive in alternative products where the EU domicile of choice has yet to be firmly established.

Although there was agreement over the broad characteristics, there was less agreement on the specific features of the ideal regime. Individual views were clearly influenced by the nature and business of the participant.

The issue of tax exempt funds, while supported by many participants, is an example of how different firms within the industry can hold polarised views. The views of participants ranged from those that support radical change through to those who support the *status quo*.

Exemption would enable UK funds to appeal to non-resident investors and tax free institutions as there would be no risk of UK tax sticking at fund level and the regime would be as certain and as simple as it could be. In addition, the compliance burden would fall as the need to complete a tax return should disappear.

However, some managers strongly oppose exemption since it may result in the loss of taxation treaty benefits. Institutional investors are seen as particularly sensitive to withholding tax.

It should be recognised that this debate may soon be rendered less relevant. There have been recent developments in the ECJ that could lead to an extension of the tax exemption for UK dividends to all dividends (i.e. those sourced from other EU states and, depending on the technical line pursued, non-EU countries)[25]. This would render many UK funds *de facto* exempt.

Other parallel ECJ developments[26] could conceivably reduce the rate of withholding tax suffered by SICAVs, thereby reducing the benefit of the UK's tax treaty network.

[25] See the Advocate General's Opinion in respect of the Franked Investment Income Group Litigation Order test case (Case C-170/05)

[26] See the Fokus Bank (EFTA Court E-1/04) and Denkavit (Case C-170/05) cases

Impact of fund domicile on the UK investment management industry and wider economy

6.1 Summary

This chapter considers the impact that the CIV domicile will have on the UK investment management industry and the wider UK economy. In particular, it considers both the direct impact of administration as well as the broader impact that domicile has on other areas of the industry.

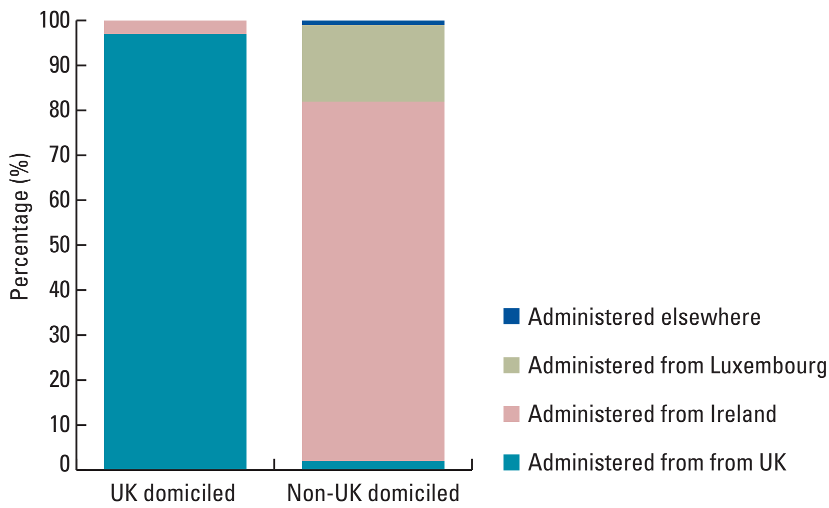
The key conclusions are:

- Fund domicile has a strong direct relationship with fund administration, as they are often located in the same centres.
- Evidence has yet to emerge that fund domicile has a direct impact on the location of core investment management. However, locating fund domicile and administration in a different location to other activities does loosen the overall cohesiveness of the industry.
- The combined corporation tax and Schedule 19 FA 1999 SDRT revenue that the UK generates directly from CIVs is estimated to be in the region of £125 million *per annum.*
- Although administration roles and associated economic benefits are hard to quantify, the growth of Ireland as an offshore centre acts as a good example of how attracting fund domiciles can grow a successful industry.
- Other locations are actively looking to grow investment management industry centres, recognising the associated economic benefits.

6.2 Impact of fund domicile on administration

All participants mentioned the impact that CIV domicile has on administrative jobs. Since most fund managers outsource much of the fund administration to Third Party Administrators (TPAs), we included these firms in our survey. Our survey of TPAs shows a strong correlation between the location of the fund and the location of administrative functions (see Figure 6.1).

Figure 6.1
Funds administered by participating TPAs per country / region



Source: KPMG / IMA Survey. The survey included four major TPAs with a presence in the UK who act for UK CIVs valued at £178.2 billion or 46 percent of total authorised FUM of £385.8 billion[27].

While the results clearly illustrate a strong link between administration and CIV domicile, it is harder to determine the related economic impact due to the lack of a clear definition of 'administration'. In particular:

- The term 'administration' covers a number of middle and back office functions. The location of the fund has a differing impact over each function.
- Administrators often manage other products including insurance funds and segregated portfolios. With business managed on functional rather than product lines, administrators admitted that it was difficult to isolate staff numbers specifically supporting CIVs.
- The administration function can often be split. It is difficult to capture all elements of the function when they exist across different companies, as well as the related roles that support administrators (for example, legal and accountancy services).

[27] Source: IMA statistics as at April 2006. The percentage represented by our survey is perhaps slightly less because the IMA statistics do not include the value of unauthorised CIVs.

Furthermore, having nominal administration and fund domicile in the same location does not always equate to the undertaking of actual administration functions. The local regulations have a significant further influence in this area, since they can demand that some element of tangible administration be located in the CIV domicile. This is particularly the case in Ireland, and to a lesser extent Luxembourg, where real administration substance is currently required alongside the CIV (see Appendix 5).

In contrast, the UK regulations do not include any specific requirement to co-locate administration functions and fund domicile. This enables UK domiciled funds to offshore administration and allows administrators to operate a hub and spoke model whereby the core functions are carried out in one centre to gain economies of scale, but with some presence maintained in the domicile of the fund.

The current proposals from the EU set out in the Green Paper 2005 appear to support a move towards the UK position, looking to loosen the regulatory link between domicile and administration (see EU Green Paper, 2005).

6.3 Impact of fund domicile on other investment management functions

The relationship between fund domicile and other functions of the investment management industry, apart from administration, is less clear. Participants stated that the location of the core investment management function has minimal bearing on the fund domicile decision and was the least important factor in making this decision (see Figure 4.1). For most participants, the core investment management function was firmly located in the UK, irrespective of the fact that many both marketed funds internationally and managed fund ranges domiciled offshore. This finding was consistent with the Oxera report, which concluded that core investment management activities appeared to be quite securely located in the UK.

Nevertheless, many fund managers are frustrated over their inability to domicile certain funds in the UK. This is largely because the UK remains a preferred CIV domicile for many participants, for a number of reasons:

- The UK market for savings is a growth area with an increasing appetite for property and other alternative asset classes. In the short to medium term, UK CIVs will continue to dominate the UK market; it will therefore be easier to sell UK funds than offshore funds into the UK market.

- Managers have confidence in the UK's regulatory regime. The FSA's approach is seen by some as highly effective in offering a comprehensive level of protection to investors and helps with the overall image of the UK industry. In addition, the independence of UK trustees is a further strength, although arguably under–appreciated by investors.
- Participants prefer to minimise fund ranges to increase operational efficiencies. Where possible, they seek to avoid the additional costs and complexity that comes from operating duplicate ranges and / or establishing specialist CIVs in offshore locations. This is particularly the case for managers who have a significant platform in the UK and only a small presence outside the UK, as extra travel and the need to assemble non-resident boards can be inconvenient.

It is this underlying preference for the UK domicile, coupled with the position of the UK as the leading European investment management centre, that has led to the continued success of the UK industry despite the underlying discontent with certain tax issues identified by participants.

However, a small number of participants are seriously considering moving pockets of investment managers from the UK. For these managers, it is not any specific tax factor, but rather the overall attitude towards the investment management industry that is leading them to consider such actions.

To the extent that there is such discontent with the UK, it is exacerbated by investment managers' concerns with the tax treatment of CIVs. Participants cited a number of specific CIV issues, principally the recent 10 percent rule for QIS and uncertainty surrounding treatment of derivatives.

This suggests that HMRC and Government policy towards CIVs has a strong influence on the perception participants have of wider Government attitudes towards the investment management industry. If participants perceive that the industry is not supported by the UK Government, then in the long term they will feel less inclined to establish or retain UK based operations.

6.4 Economic impact arising from the fund domicile decision

The economic impact for the UK economy has three aspects:

- The direct tax revenues from UK domiciled funds.
- The economic benefits for the UK economy from administration.
- The economic impact for the UK economy from other investment management functions.

6.4.1 Direct tax revenues

We estimate a figure of £125 million per annum[28] for the total tax receipts from UK CIVs.

- UK funds pay very little tax despite being subject to corporation tax at a rate of 20 percent on net income. We estimate an annual charge in the region of £85 million. This is pro rated based on the response from administrators included in the survey, who reported a tax charge of £42 million or 2.4bp from the funds they administered.

  As the £85 million receipts are most probably in respect of overseas equities, the annual tax take could fall further if the ECJ decides that EU sourced dividends should be exempt in the same way as UK dividends (see Section 5.6).

- We estimate an annual charge of £40 million for Schedule 19 FA 1999 SDRT. This is pro rated based on the figures from three administrators who administer £129.2 billion of UK funds, and reported an SDRT charge of £17.4 million.

The £125 million total should be assessed in the context of annual tax receipts of £483 billion (Adam S. and Browne J., 2006). This supports the exemption case as the cost to the Exchequer of such a move would be small. However, HMRC would need to ensure that exemption would be accompanied by suitable anti–avoidance measures in order to properly replace a key function of the current tax regime.

It is harder to gauge the impact that policy towards CIVs has on VAT receipts. In–depth analysis beyond the scope of this report is required to answer this question. The impact on VAT receipts depends on a host of factors, for example, the nature of the CIV investments, the domicile of the manager and the nature of the supplies made. Moreover, the conclusion could change significantly after the full impact of the Abbey National case (C-169/04) and EU consultation on the financial services legislation is known. Arguably, any changes in policy that affect the VAT treatment of the management company could have a greater impact on the location of the manager rather than the CIV.

28 Administrators were asked to provide data in respect of the most recent accounting year for the CIVs they administer – the accounting year may vary from fund to fund.

6.4.2 Economic impact of administration

As stated earlier, it is difficult to define clearly the administration function and the related employment and economic benefits. However, it is clear that tangible economic benefits flow from undertaking administration functions. Within the UK there exist areas where the presence of fund administration has a significant and important role in the local economy (including Edinburgh, Essex and Manchester). Although not directly quantifiable, the location of the administration function in the UK benefits the economy, through providing direct jobs and contributing to tax receipts. Furthermore, accounting and legal services are often closely linked to administration and provide similar economic benefits.

A clearer way to illustrate the economic benefits of fund administration can be seen by analysing the growth of Dublin's International Financial Services Centre (IFSC). As Appendix 3 describes, the IFSC was established in 1987 and has grown rapidly (in 2002 it was estimated to employ 10,700 people and to generate Irish corporation tax returns of EUR 700 million in addition to economic employment benefits). The successful positioning of Dublin as an offshore administration centre for CIVs has been a key factor behind this growth.

As Dublin undertakes little actual investment management, the employment and related economic benefits are driven almost entirely through administration-related activities. Dublin has been able to build on the initial tax benefits of the IFSC and support of the authorities to develop itself as a centre of excellence for certain activities (for example, hedge funds and money market funds), such that firms look to locate CIVs in Dublin because of this expertise. Services provided include:

- Management companies.
- Fund administration / fund accounting.
- Trustee / custodial services.
- Company secretarial and shareholder services.
- Audit and accounting services.
- Legal advisory services.

However, the initial low cost advantage is being eroded as strong growth and demand for expertise has led to a skills shortage and related cost pressures. Dublin is now outsourcing administration jobs to other Irish locations.

6.4.3 Economic impact from other investment management functions

The UK is still acknowledged as the leading investment management centre in Europe, and as such, clearly contributes significantly to the UK economy through employment[29] and tax revenues.

While it is difficult to estimate accurately the total value the industry provides to the UK economy, from anecdotal evidence other jurisdictions believe that the industry has significant economic benefits and are acting accordingly:

- In 2004 IDA Ireland engaged Deloitte to consider the future of the international financial services sector in Ireland. The following recommendation shows that the UK's competitors have ambition.

"During our consultation process it was evident that asset management business is worth pursuing but requires a long term approach and strategy. The focus must be on getting the people to Ireland who manage the assets… All of these niches offer opportunity to Ireland to build on the small, but evident, 'shoots' of asset management activity already here."

- The French trade association, Association Française de la Gestion Financière (AFG), sees a future for Paris as the Boston of Europe[30], i.e. Europe's asset management centre.

- The Dubai International Financial Centre (DIFC) aims to play host to 20 percent of the world's investment funds[31]. Along with the funds, the DIFC aims to attract investment managers – the front, middle and back office.

As such, the UK cannot afford to be complacent in this matter. In particular, it should not be assumed that the extent to which domicile influences other investment management functions will remain minimal in the long term. With competition intensifying, anything that weakens the UK's leading industry position should be of concern to the UK Government.

29 The IMA estimates that 22,000 to 25,000 UK based jobs are associated with the asset management industry (IMA Asset Management Survey, July 2006)

30 Pole de competitivité, *Le 'Paris de La Gestion' doit devenir le 'Boston de l' Europe'*, AFG Annual Report

31 FTFM, *Dubai aims to host 20% of world's funds,* 26 June 2006

Recommendations

7.1 Summary

The report shows that tax and regulation are the principal factors participants consider when selecting fund domicile. However, there was widespread dissatisfaction with the tax authorities' interaction with the investment management industry. This covered both the approach and attitude of HMRC and the nature and complexity of the specific tax regulations. As a result, there is a strong belief from participants that the UK is a less attractive place than competitors in which to domicile funds, with managers increasingly looking to domicile funds offshore. The growth of initially Luxembourg, and more recently Ireland as offshore centres illustrates this trend.

While evidence suggests that fund domicile does not currently have a direct correlation with the domicile of investment management functions, there is a close correlation between fund domicile and administration functions. As such, although much of the UK investment management industry is not negatively impacted by the trend to domicile funds offshore, administrative jobs to a large degree still follow the domicile of funds and accordingly are expected to follow the funds offshore. This has a negative impact on the UK economy through a loss of jobs and associated tax revenues. Any future negative influence that fund domicile may have on the core investment management functions will have a similar, but greater, economic impact.

The UK economy does not recover the economic benefits lost when funds are domiciled offshore. In effect, these benefits are potentially lost for good to other locations; the economic growth of Ireland demonstrating this point.

Although participants recognise that it will not be possible to reverse the growth of Luxembourg and Ireland, they do believe that the EU domicile of choice for alternative and progressive fund types (for example, hedge funds and property funds) has not yet been determined. There is an opportunity for the UK to compete with other locations and win this business. This would require HMRC and other authorities to work constructively and closely with the industry to agree a tax regime that would support rather than hinder the growth of this type of business in the UK.

The following recommendations are potential ways to support this initiative.

7.2 Recommendations

7.2.1 Improved consultation and trust between the industry, HMRC and the FSA

Participants have highlighted a lack of constructive consultation between HMRC and the industry, together with a disjointed approach between the tax authorities and the FSA resulting in different and / or unclear messages. This has created uncertainty and has impeded industry developments.

This compares poorly against Ireland and Luxembourg, where tax, regulatory and other authorities are both supportive of the industry and work together to deliver a coherent overall approach to industry issues.

Participants would like to see the UK develop the same collaborative and constructive approach, recognising that this requires better engagement from both the industry and the authorities. The industry should endeavour to understand and address or challenge HMRC concerns over tax avoidance and, where necessary, offer properly targeted anti-avoidance measures.

7.2.2 The industry and HMRC to promote a better understanding of the industry

An underlying frustration from participants has been the belief that HMRC is neither focused on, nor sufficiently understands, the investment management industry. It is perceived that the industry is only considered as an afterthought in the design of tax regulations, and suffers accordingly. There should be greater focus by HMRC on investment management as a separate sub-set of financial services. CESR has established an asset management working group in parallel with insurance and banking groups and this is an attractive precedent. One participant suggested that HMT, HMRC, the FSA and the industry should form a product development committee along the lines of the working group formed in Ireland to develop the CCF. This is a sub-group of an industry-led committee, concerned with the wider Irish financial services sector. It is overseen by the Department of An Taoiseach.

7.2.3 Address the property fund conundrum

Participants are keen to provide UK domiciled open-ended property funds for a range of UK investors, but are forced to domicile such funds offshore due to current tax rules. HMRC should work with the industry to agree an appropriate tax regime for these funds.

7.2.4 Seriously consider abolition of the SDRT Schedule 19 regime

This funds-specific SDRT regime adds complexity to the UK tax regime. It creates an additional compliance burden for managers, as well as making UK funds harder to understand and therefore less attractive to investors when marketed offshore. HMRC should consider abolishing this regime, together with introducing appropriate anti-avoidance measures.

7.2.5 Allow authorised funds to trade without incurring a corporation tax charge

The UK tax regime distinguishes between trading and investment activities, subjecting the former to corporation tax at fund level. HMRC should consider removing this distinction and exempting trading profits from tax.

However, if thought necessary, this may have to be accompanied by the introduction of a properly targeted anti-avoidance measure to help ensure that it would only be applicable for funds that are managed at arm's length (perhaps along the lines described by the UK's investment manager exemption at section 127 FA 1995 and Schedule 26 FA 2003).

7.2.6 Pending the ECJ decisions, consider full tax exemption at fund level

The taxation of funds was identified by participants as a significant negative issue of the UK tax regime, and it is recognised that UK funds find it difficult to compete on equal terms with tax exempt offshore funds. However, there is no clear consensus supporting a tax exempt status for UK funds, largely due to the impact that this could have on UK funds' ability to access the benefits of tax treaties.

The outcome of current ECJ cases could significantly reduce any treaty benefits, and enable the industry to reach a consensus view. HMRC should seriously consider the case for exemption should such a consensus be reached.

Appendix 1 – List of participants

AXA Investment Managers

Barclays Global Investors

Baring Asset Management

Cazenove Capital Management

Close Fund Management

Crédit Agricole Asset Management

F & C Fund Management

Fidelity Investment Services

Franklin Templeton Investment Management

Gartmore Investment Management

Goldman Sachs Asset Management International

Henderson Global Investors

HSBC Global Fund Services

HSBC Investments (UK)

Insight Investment Management

Investec Fund Managers

JP Morgan Asset Management

Legal & General (Unit Trust Managers)

M & G Securities

Mellon European Fund Services

Merrill Lynch Fund Managers

Morley Fund Management

New Star Investment Funds

Pimco Europe

Schroder Unit Trusts

Standard Life Investments (Mutual Funds)

State Street Bank and Trust Company

The Bank of New York

Threadneedle Investments

UBS Global Asset Management Funds

Appendix 2 – Structures covered

ICVCs

The open-ended corporate form is widely accepted across Europe. The perception that continental investors are wary of trust based vehicles led to the introduction of OEICs in the UK in 1997 and they now account for more than 60 percent of authorised funds under management in the UK.

The SICAV, which appears in Luxembourg and France, is the continental counterpart of the OEIC.

Unit trusts

Unit trusts are popular in the UK and Ireland, but not in jurisdictions with little or no experience of trust law. They do not have legal personality – investors' assets are held on trust by trustees.

Authorised Unit Trusts (AUTs) are trust based schemes that have been authorised by the FSA for sale to the public. It is FSA and HMRC policy to treat OEICs and AUTs as equivalent products.

UUTs are trust based schemes that do not have FSA authorisation. Such trusts are subject to general trust law and the investment powers of the manager are typically laid down in the trust deed. In practice, the vehicle is only suitable for UK based pension funds and charities because investors must be exempt from capital gains tax in their own right for the vehicle to be exempt from capital gains in its own right.

Contractual schemes

The Luxembourg FCP and Irish CCF are examples of contractual schemes. Like unit trusts they do not have legal personality, but are formed when investors contract with the scheme manager for their assets to be managed on a pooled basis.

They are a popular vehicle for retail investors on the continent, but do not tend to sell into the UK market because they are tax transparent. However, this feature means that they are a natural choice of vehicle for pension funds wishing to pool resources and preserve treaty benefits.

Investment trusts

In the UK, an investment trust is an investment company that meets certain tax criteria enabling it to dispose of investments without incurring a corporation tax charge. Unlike OEICs, investment trusts are closed–ended and are not authorised by the FSA. They are listed on the London Stock Exchange.

Appendix 3 – Ireland’s International Financial Services Centre (IFSC)

The following overview appears on the IFSC Web site (http://www.ifsconline.ie/). As the extract mentions, the terms of the IFSC changed with effect from 1 January 2006, but it has provided a bed-rock for Ireland’s financial services sector.

“Dublin's IFSC, which was set up by the Irish Government with EU approval in 1987, is globally recognised as a leading location for a range of internationally traded financial services, including banking, asset financing, fund management, corporate treasury management, investment management, custody and administration and specialised insurance operations.

The centre is a vibrant part of the Irish economy. Recent figures showed that the Irish Exchequer collected more than €700m in corporation tax from IFSC companies in 2002. An estimated 10,700 employees work in the IFSC, and this figure is expected to grow by 1,000 this year.

According to the Central Bank, the net asset value for collective investment schemes for regulated funds was just under €424 billion at the end of August 2004. At the end of October 2005, a total of 3,683 funds and sub-funds were authorised.

The IFSC was established in 1987 under legislation designed to boost activity and employment in the Irish economy. The Government had identified the growth potential of the international financial services sector and recognised that Ireland had the capacity to develop in the industry because of its well developed financial infrastructure, a sophisticated internal and international communications system and a young and highly educated population.

The Finance Act, 1986, introduced financial incentives to encourage urban renewal and investment by the private sector. The Finance Act 1987 established a special 10 percent corporation tax rate for certified companies setting up in the IFSC. From the end of 2002, this 10 percent rate ceased to apply to financial services companies, except for those operations that set up before before July 1998, which will continue to avail of the rate until the end of 2005. All other operations are now subject to the standard corporation tax rate of 12.5 percent on trading income.

From the 1st January 2006, Companies in the IFSC in Dublin will pay tax at the normal corporation tax rate of 12.5 percent, this special IFSC rate ends in accordance with agreements between Ireland and the EU on state aid rules. The 12.5 percent is still below the corporation tax rate of many of Ireland's European competitors; although several new EU countries from eastern and central Europe have also slashed their corporation tax rates to emulate Ireland's achievements in attracting foreign direct investment.”

Appendix 4 – Comparison of tax regimes

	Ireland	Luxembourg	UK
Type of fund	Variable Capital Investment Company (VCIC)	SICAV	Authorised Fund
Fund taxable on income?	No (except for Irish residents and subject to administrative requirements)	No	Yes, at 20 percent (deduction for interest distributions)
Fund taxable on capital gains?	No	No	No
Distribution of income mandatory?	No	No	Yes
Local investor taxed on distributions received?	Yes (20 percent)	Yes	Yes
Investor taxed on capital gains?	Yes (23 percent)	No (if <10 percent held for >six months)	Yes
Taxation depends on asset type in whichthe fund invests?	No	No	Yes – distinction between bond funds and other funds

UK authorised funds

Authorised funds are subject to UK taxation in accordance with the general rules for UK companies. However, there are two notable exceptions to this, which are that authorised funds are exempt from capital gains tax and are subject to a lower rate of corporation tax (currently 20 percent) than the standard rate (currently 30 percent). In practice, although funds are taxable entities, little tax is paid by funds.

Authorised funds are deemed to distribute all of their income, net of expenses and tax, regardless of whether the income is paid out to investors or accumulated and the roll up of income within an authorised fund is taxable. It is therefore necessary that funds maintain distribution accounts for tax purposes.

As taxable entities, funds are required to submit annual tax computations and returns to HMRC.

There is a special SDRT regime for OEICs and unit trusts. SDRT is chargeable at 0.5 percent of the share / unit surrender value, however this can be reduced by two formulae specified in Schedule 19 FA 1999. The first formula reduces the SDRT charge to the extent that the total number of shares / units sold is lower than the total number surrendered in a two week period. The second formula can reduce the SDRT by the proportion of the fund's assets that are exempt bonds and non-UK shares.

The UK tax legislation distinguishes between bond funds and non-bond funds. In general, bond funds would not normally generate taxable income as distributions made by qualifying bond funds constitute interest distributions and are therefore tax deductible, however non-bond fund distributions are treated as dividend distributions and are therefore not tax deductible.

Bond funds

To qualify as a bond fund, greater than 60 percent of assets must be held in qualifying investments which are broadly fixed income securities and cash. The qualifying investments test must be met throughout the distribution period which requires constant monitoring by the fund. Income tax at a rate of 20 percent must be withheld at source on interest distributions, unless payments are made to certain defined recipients in which case the payments can be made gross.

Other funds

Distributions from the fund are not tax deductible at fund level and are treated as a dividend in the hands of the recipient. Dividend income at fund level from UK companies is not taxable, however dividends from non-UK companies are subject to tax with potential relief under double tax treaties. Distributions to corporate recipients are subject to corporate streaming rules in the hands of the recipient. The corporate streaming rules effectively prevent the investor gaining a tax advantage by receiving distributions as tax exempt franked investment income if part of the distribution relates to unfranked investment income.

Luxembourg

Luxembourg funds are exempt from Luxembourg income and capital taxes with the exception of registration duty and annual subscription tax. Registration duty comprises a one-off payment on formation, currently EUR 1,250 (and no further amounts are payable on any subsequent increases in capital). Annual subscription tax is currently 0.05 percent of the value of net assets of the fund, although a reduced rate applies to certain funds. As from 1997 this tax has been cancelled for net assets that a Luxembourg agreed investment fund has invested in another Luxembourg investment fund, subject to the Luxembourg subscription tax (funds of funds).

Funds, which invest in money market instruments and / or in bank deposits (cash funds), are subject to this tax at a reduced rate of 0.01 percent. Private investment funds (the so-called special or dedicated funds reserved to institutional investors) are also subject to this tax at a reduced rate of 0.01 percent per annum. This reduced subscription tax rate of 0.01 percent also extends to a sub-fund or a separate class of shares created within a fund if all the shareholders of such sub-fund or class are institutional investors.

Gross roll up of income within the fund is permissible within Luxembourg funds and there is therefore no need to keep accounting records splitting income and capital. Income is accounted for net of withholding tax so tax is not disclosed separately in accounts.

Distributions made by Luxembourg funds are not subject to withholding taxes (except for the Savings Directive).

No stamp duty or other transfer taxes are payable in the purchase or sale of shares or securities in Luxembourg.

Ireland

Investment undertakings are not chargeable to tax on income or gains except on a gain arising on a 'chargeable event'. Chargeable events mainly concern actual realisations of income and gains, i.e. distributions and redemption, repurchase, transfer of and cancellation of units. However, from 2006 a deemed realisation will also occur every eight years following the acquisition of the units. Regular distributions are subject to tax at the standard rate of income tax, currently 20 percent, and all other chargeable events are taxed at the standard rate of income tax plus three percent, i.e. 23 percent. However, exemptions exist where a chargeable event is triggered in respect of certain unitholders including pension schemes, life companies and, importantly, non-residents.

The Irish CCF is treated differently for tax purposes than other regulated funds. As a CCF is a fiscally transparent entity, the income and gains are considered to be income and gains of the unitholders irrespective of whether an actual distribution is made.

Although technically all Irish funds have access to Ireland's double taxation treaty network, in practice this depends on the wording of each treaty and the approach of the other tax authority.

Withholding tax of 20 percent applies to dividends and distributions, however Irish investment undertakings have a specific exemption from the requirement to withhold. Additionally, Irish entities paying a dividend / distribution to such a fund are not required to withhold tax on the payment providing the fund has filed a signed declaration with the distributing company before the payment is made.

The transfer of shares / units in mutual funds is normally exempt from stamp duty on transfer.

Appendix 5 – Local regulation

CIVs in Europe intended for cross-border distribution are governed by the UCITS Directive (85/611/EEC) and its amendments. It is the responsibility of the regulator in each Member State to take this Directive and incorporate the rules into their local regulation. The key requirements of the UCITS Directive include:

- The management company must have initial capital of a least EUR 125,000.
- Persons who effectively conduct the business of a management company must be of sufficiently good repute and be sufficiently experienced.
- Application for authorisation must be accompanied by a programme of activity, setting out *inter alia* the organisational structure of the management company.
- Both its head office and its registered office must be located in the same Member State.
- Both the management company and the depositary must be located in the same Member State.

The relevant regulators for UK, Luxembourg and Ireland are the FSA, Commission de Surveillance du Secteur Financier (CSSF) and the Irish Financial Services Regulatory Authority (IFSRA) respectively. Each of the regulators have incorporated the UCITS Directive into their regulatory framework.

As noted above, the UCITS Directive requires that the head office, registered office, management company and depositary of a CIV must be in the same Member State. The regulators may impose further restrictions on location of activities using their local regulations. In the UK, the rules do not impose any further restrictions and therefore it is possible to have fund administration in a separate location to the fund domicile. However, the UCITS Directive does require that the competent authority be informed if any functions are delegated to a third party.

The Luxembourg and Irish regulations impose restrictions on the functions that must be performed locally for domestic funds. These centre on fund administration and shareholder services. The following detail illustrates the types of services that follow the CIV.

Luxembourg

- The central administration of any Luxembourg Undertakings for Collective Investment must be located in Luxembourg. This requirement must ensure that the supervisory authority, the depository and the auditor may easily perform their respective legal duties.
- Issues and redemptions must be carried out in Luxembourg (the CSSF considers that tasks as intimately connected as the execution of issues and redemptions and the keeping of the register of participants may only be entrusted to one single provider of services).
- The register of participants must be kept in Luxembourg.
- The calculation of the net asset value must be carried out in Luxembourg.
- Accounts must be kept and the account documents must be available in Luxembourg.
- The prospectus, financial reports and all other documents intended for investors must be established in cooperation with the central administration in Luxembourg.
- The correspondence with shareholders must be carried out from Luxembourg.

Ireland

Specifically, the following activities must be carried out in Ireland:

- Calculation of the net asset value, including the CIV's income and expense accruals.
- Preparation of semi-annual and annual accounts.
- Maintenance of the fund's financial books.
- Payment of the fund expenses.
- Calculation and payment of dividends and distributions.
- Supervision of the orderly liquidation and dissolution of the fund.
- A range of shareholder service activities.

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