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Profit fragmentation consultation - effect on investment management groups

- The Government has published a consultation paper setting out its intention to legislate against what it terms "profit fragmentation schemes" with effect from April 2019. As the government perceives it, such schemes involve the diversion of profits attributable to UK based trading activities to "offshore" structures with insufficient substance to justify the allocation of profits in this way. The consultation paper states that the aim of the proposed legislation will be to ensure that the amount of profit appropriate to UK business activity is taxable in the UK. As well as introducing a new basis of charge, and perhaps of greater concern to the industry, it is proposed that a taxpayer notification and advance tax payment regime be introduced as part of the new rules.
- This note considers the potential implications of the introduction of this regime for investment management businesses with non-UK corporate structures owned by UK resident individuals.

Current UK tax framework for investment management businesses

- Under current law, it is possible for some of the profits of investment management businesses owned by UK resident individuals operating within the UK to arise to non-UK corporate structures beneficially owned by such individuals, without those profits being subject to UK tax.
- This is subject to the navigation of a number of UK tax rules, including the disguised investment management fee rules ("**DIMF Rules**"), transfer of assets abroad rules and transfer pricing rules. Taken together, the effect of these rules is broadly that, for profits to arise to a non-UK manager company free from UK tax, the company must have a commercial purpose in the relevant non-UK jurisdiction, profits allocated to it must reflect the functions performed by it and (where there is a controlling shareholder) the company must be subject to corporate taxation (broadly) equal to 75% of the equivalent UK corporation tax liability to which a UK company would have been subject.

New profit fragmentation legislation

- The first element of the profit fragmentation initiative is to introduce targeted legislation under which the profits of a UK business will be increased, for UK tax purposes, by the amount of profits attributable to that UK business but which have been diverted to a non-UK low-tax jurisdiction. This legislation will apply if the following four conditions are met:
  - **Condition A**: there are profits attributable to the professional or trading skills of a UK resident individual ("A"), whether A carries on business as a sole trader, in partnership or through a company;
  - **Condition B:** some or all of those profits arise to an entity ("Z"), resulting in "significantly less" tax being paid on those profits than would be paid if the profits had arisen to A;
  - **Condition C:** A, or a person connected with A, can enjoy economic benefits from the profits of Z; and
  - **Condition D**: it is reasonable to conclude that all or part of Z's profit is excessive, having regard to the profit-making functions it performs (i.e. Z is over-rewarded), with the excess instead being attributable to the connection between Z and A.
- The consultation paper specifies that the "significantly less tax" condition (B) will be met where Z is subject to 80% or less of the tax that would have been paid if the profits had arisen in the UK (it is not clear whether this is by reference to corporate, rather than individual, UK tax rates). For Condition C, the paper states that the power to enjoy test will be similar to the test used in the DIMF Rules – it remains to be seen whether an exception similar to the "shareholder exception" in the DIMF Rules (the effect of which is to exclude from a DIMF inclusion minority shareholders of a commercial offshore structure) will be available. It seems that the application of Condition D will essentially turn upon the local substance of the non-UK structure in question.
- Where the rules apply, the individual A's trading profits (or, if they act through a UK company, the company's profits) will be increased by the profits that have arisen to Z. If A does not report UK trading profits, then the profits of Z will be assessed on A as those of a standalone trade. The paper does not specify whether all of Z's profits, or only the excessive proportion of Z's profits, will be added to A's profits.
- The second element of the initiative is to introduce a notification and advance payment system. Broadly, where arrangements meet Conditions A, B and C (but not D) of the new legislation, businesses will be required to notify HMRC of the existence of those arrangements. HMRC will then be able to require the payment of tax, following which they will review the action taken and consider any applicable adjustments. Taxpayers would only be able to appeal HMRC's decision post-expiry of HMRC's review. If introduced as proposed, this would represent a draconian measure as many managers with entirely commercial (and tax robust) structures would be required to notify.

Potential application to investment management groups

- Investment management groups with UK resident principals operating through non-UK corporate structures may be concerned as to whether they may be caught by this new legislation, and thereby have profits of their non-UK corporate group (the entity Z) added to the profits of the group's UK resident principals. Others who believe they would not satisfy Condition D due to the commerciality of their arrangements will be concerned with the notification and advance payment proposals.
- Groups owned by a small number of senior principals would be particularly vulnerable to the new rules, since their profits may be more readily seen as "attributable" to a particular individual for the purposes of Condition A. However, the paper's examples of arrangements against which the legislation is targeted generally concern businesses owned by one particular UK resident individual. Further, the consultation talks about affected offshore structures having "little or no substance" and benefitting from the "exploitation of a UK resident's earning capacity". The consultation also suggests that affected structures are likely already caught by existing legislation but that it is proving too onerous for HMRC to counter these structures with the existing rules. It may be, therefore, that investment management businesses owned by a wider group of principals and which currently do not fall foul of the existing anti-avoidance rules on a technical basis would generally fall outside the regime's scope. However, the potential breadth of the new rules (and particularly the notification and advance payment obligations) will be a concern to these legitimate structures. A particular concern for investment management groups is that it appears that all "profits" arising within the entity "Z" (and not just trading profits) will be covered, meaning that, for example, "house carry" arrangements where groups hold a portion of fund carried interest through their manager corporate structure could be swept into the UK tax net for UK resident executives with power to enjoy such sums.
- A further concern is that, for a business to trigger the requirement to notify HMRC, only Conditions A, B and C (and not D) must be met. As such, an investment management business would appear to have to notify HMRC if it is operated out of a corporate structure established in a low-tax non-UK jurisdiction and beneficially owned by its UK resident principals, regardless of the substance of, or commercial justification for, that structure. This outcome appears to run contrary to the stated intention of the government that commercial operations in low tax jurisdictions are not intended to be caught.

Conclusion

- The consultation paper makes clear that the Government has no desire to affect genuine commercial arrangements with this legislation. It may therefore be the case that this initiative should not affect the operation of investment management groups in accordance with their current practice, with certain functions carried out in non-UK jurisdictions through a non-UK corporate structure owned by UK resident individuals. However, it will be necessary to monitor carefully the development of this initiative.

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