

HM Revenue & Customs

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Dear Sir/ Madam

HMRC consultation on diverted profits tax

The Investment Association¹ welcomes the opportunity to comment on the diverted profits tax (DPT) consultation.

We recognise the importance of preventing the erosion of the UK tax base via contrived arrangements. More generally, we support the broader objectives of the OECD/ G20 BEPS Action Plan.

We agree with the purpose and intent of the proposals on DPT. However, we are concerned that the broad manner in which the proposals are drafted may inadvertently capture some arrangements relevant to investment managers that are truly commercial. We note that in investment management, as in finance generally, some cross border arrangements are in place for regulatory purposes, and for the purposes of being able to access capital markets, invest more freely across borders, and offer savings products to customers throughout the world.

We have set out in **appendix 1** our description of the features of the Undertakings for Collective Investment in Transferable Securities (UCITS) and Alternative Investment Fund Manager (AIFM) Directives relevant to the analysis of the impact of DPT.

In **appendix 2** we have set out an example of the functions of a non-UK UCITS management company (ManCo) that we believe should not be caught by the insufficient economic substance condition. We believe such an example would be a useful addition to the draft guidance in DPT1240 and would help clarify that DPT should not capture the regular operation of a UCITS or AIF ManCo.

¹ The Investment Association (formerly the Investment Management Association) represents the asset management industry operating in the UK. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes.

Appendix 3 includes extracts of the relevant provisions of the UCITS IV implementing Directive 2010/43/EU, which sets out the detailed role of a UCITS ManCo.



The UK Investment Management Strategy

Our members are responsible for the management of over £5.4 trillion of assets, which are invested on behalf of clients globally. These include UCITS and AIFs and a wide range of other clients. Our members manage over 35% of European assets under management, yet only 11% of European funds are UK domiciled. This indicates the extent to which UK investment managers act for overseas clients, and in 2012 UK investment managers' contributions to net export earnings accounted for £5.3bn, which is over 6% of UK services exports.

In Budget 2013 the Government announced its commitment to improving the UK's competitive position in the investment management sector. Its report entitled 'The UK Investment Management Strategy' highlighted a decline of the UK as a fund domicile over the previous decade and acknowledged this was partly due to a failure in adequately addressing concerns over rules and processes in the UK.

The strategy identified key areas for improvement and taxation was among them. The Government recognised the importance of a simple, fair and stable tax regime and committed to simplifying and streamlining taxes on the sector to ensure that the tax framework best meets investor needs.

Much work has been done to improve the regulatory and tax environment in which funds operate. It's critical that the introduction of DPT does not undermine the achievements made to date in improving the tax environment.

Furthermore, even where DPT does not ultimately impact on a particular fund manager, reaching this conclusion is likely to be burdensome as the draft legislation is so broad and fact specific. We believe that the inclusion of an example (such as that in Appendix 2) would help clarify the position of fund managers.

Thank you again for the opportunity to comment on the draft legislation. I am available at your convenience to discuss anything in this letter at jorge.morley-smith@theinvestmentassociation.org or on +44 (0)20 7831 0898.

Yours faithfully

Jorge Morley-Smith
Director, Head of Tax

Appendix 1 – Analysis of the proposals in the context of the Undertakings for Collective Investment in Transferable Securities (UCITS) and Alternative Investment Fund Manager (AIFM) Directives



The UCITS IV Directive and the AIFM Directive provide the legal framework for the operation of the Single Market in funds and asset management – one of the most successful manifestations of the EU Single Market. These Directives ensure that UK managers are freely able to manage funds throughout the EU, and are able to sell UK funds to investors throughout the EU. More importantly, UK savers are able to benefit from access to a wider range of fund products from throughout the EU – increasing competition and lowering costs to consumers.

UCITS IV and AIFMD provide detailed rules on the roles and responsibilities of the management company (ManCo). The ManCo is generally responsible for the oversight of all the functions of a UCITS or AIF. An extract of the relevant provisions is included in Appendix 3.

UCITS IV allows a ManCo in one EU jurisdiction to act for a UCITS in another jurisdiction. This ManCo “passport” allows managers to sell UCITS and AIFs across the EU without having to establish a ManCo in each jurisdiction.

Before UCITS IV, where an investment manager had a number of different fund ranges a number of separate local ManCos was required. Although UCITS IV changed this by permitting a single ManCo, in practice few investment managers have merged ManCos and it remains the case that most UCITS retain ManCos in the jurisdiction where the UCITS is domiciled.

It is necessary for a ManCo to have a strong, industry-connected board that meets regularly in order to fulfil the ManCo’s commercial and legal obligations, and to interact with the local regulator. Under UCITS IV, the ManCo is charged with this formal responsibility, which cannot be laid off to anyone else. Moreover, the home country regulator needs to be satisfied that the composition and expertise of the board, the governance structure, and the control environment allow the board of the ManCo to carry out in a satisfactory manner the obligations formally placed on the ManCo. Thus, the board must have real substance and expertise and it must demonstrate that it is discharging this obligation. This is clear from the UCITS IV implementing Directive 2010/43/EU, which sets out at Article 9 the detailed and onerous obligations laid on the board.

It is common for day-to-day fund management functions to be outsourced to other providers. One of these is the investment management function, but back and middle office administration are also typically outsourced to other providers on the grounds of cost and economies of scale. This is common both for UK and non-UK funds. Thus, other than in respect of the higher levels of strategic management, all other core functions may be outsourced to others, typically to independent third party suppliers, but also to service providers within the same group.

It is clear that a UCITS ManCo is generally not used in order to divert profits away from the UK. The ManCo is typically located in a jurisdiction where there is a clear commercial nexus. This might be where the head office of the fund manager is located, or in most cases where the majority of the funds managed by the ManCo are established, but it will not be located somewhere where there is no meaningful commercial nexus.

The rules should therefore make it plain that a ManCo that subcontracts investment management functions to a UK company should not cause the insufficient economic substance condition to be met.



Appendix 2 – Example 5: Section 3 not applying



1. In this structure a UK Company (UKCo) provides investment management services to a related fund manager located in a low tax jurisdiction (ManCo).
2. ManCo manages a range of Undertakings for Collective Investment in Transferable Securities (UCITS) and/or Alternative Investment Funds (AIFs) domiciled in the same low tax jurisdiction. The funds are distributed to investors throughout the world.
3. ManCo is responsible for the management functions of the UCITS/AIFs and discharges its obligations pursuant to the UCITS IV implementing Directive 2010/43/EU (Article 9) and/or AIFM Directive 2011/61/EU and implementing Regulation AIFMR No 231/2013.
4. ManCo's Board is made up of specialists with significant experience and knowledge of fund management and who are able to oversee and approve all functions that it delegates to third parties and/or connected parties.
5. ManCo's Board meets regularly in order to fulfil the ManCo's commercial and legal obligations, and to interact with the local regulator.
6. In this situation, the economic value generated by ManCo far outweighs the financial benefit of the associated tax reduction. It is not the case that the existence of ManCo, or the outsourcing of investment management functions to UKCo is a transaction designed to secure the tax reduction.
7. The insufficient economic substance condition is not met, despite there being an effective tax mismatch outcome.



Control by senior management and supervisory function

1. Member States shall require management companies, when allocating functions internally, to ensure that senior management and, where appropriate, the supervisory function, are responsible for the management company's compliance with its obligations under Directive 2009/65/EC.
2. The management company shall ensure that its senior management:
 - (a) is responsible for the implementation of the general investment policy for each managed UCITS, as defined, where relevant, in the prospectus, the fund rules or the instruments of incorporation of the investment company;
 - (b) oversees the approval of investment strategies for each managed UCITS;
 - (c) is responsible for ensuring that the management company has a permanent and effective compliance function, as referred to in Article 10, even if this function is performed by a third party;
 - (d) ensures and verifies on a periodic basis that the general investment policy, the investment strategies and the risk limits of each managed UCITS are properly and effectively implemented and complied with, even if the risk management function is performed by third parties;
 - (e) approves and reviews on a periodic basis the adequacy of the internal procedures for undertaking investment decisions for each managed UCITS, so as to ensure that such decisions are consistent with the approved investment strategies;
 - (f) approves and reviews on a periodic basis the risk management policy and arrangements, processes and techniques for implementing that policy, as referred to in Article 38, including the risk limit system for each managed UCITS.
3. The management company shall also ensure that its senior management and, where appropriate, its supervisory function shall:
 - (a) assess and periodically review the effectiveness of the policies, arrangements and procedures put in place to comply with the obligations in Directive 2009/65/EC;
 - (b) take appropriate measures to address any deficiencies.
4. Member States shall require management companies to ensure that their senior management receives on a frequent basis, and at least annually, written reports on matters of compliance, internal audit and risk management indicating in particular whether appropriate remedial measures have been taken in the event of any deficiencies.
5. Member States shall require management companies to ensure that their senior management receives on a regular basis reports on the implementation of investment strategies and of the internal procedures for taking investment decisions referred to in points (b) to (e) of the paragraph 2.
6. Member States shall require management companies to ensure that the supervisory function, if any, receives on a regular basis written reports on the matters referred to in paragraph 4