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Tax

Will Increased Tax Rates and More Onerous Regulation Cause Hedge Fund Managers to Leave London?

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By Christopher Faille, *Hedge Fund Law Report*

London is one of the world's premier centers of hedge fund management. A recent ranking of the world's 11 most successful hedge fund managers listed two headquartered in London: Winton Capital Management and Brevan Howard Asset Management. But there has been, for months now, a good deal of talk about an exodus of hedge fund managers from the U.K. That talk has been fueled by two factors: recent tax law changes and the European Commission's proposed Alternative Investment Fund Managers Directive (Draft Directive).

Tax Law Changes

The highest U.K. tax bracket (or "band") until this year has included all earnings over £39,825. Income below that level yet above a personal allowance was taxed at the basic rate of 22% (recently reduced to 20%). Income above that level was taxed at 40%. But on April 22, 2009, Alistair Darling, Chancellor of the Exchequer, announced that there would be a new band, a 50% income tax rate for those earning more than £150,000 per year. This will go into effect with the beginning of the next U.K. tax year on April 6, 2010.

Another hit to those in that top band comes with the withdrawal of previously-available tax relief on pension contributions. Under the system available until this spring, even very high earners could put £255,000 into a pension and enjoy tax relief of 40% of that amount, or £102,000. But under the new budget, the value of tax relief on a pension contribution has fallen to a maximum of £51,000.

Draft Directive

Talk of flight has also been stoked by concern about the European Commission's proposed Alternative Investment Fund Managers Directive (Draft Directive). For more on the Draft Directive, see "Future Regulation of Private Funds: How the Draft EU Directive & US Legislative Proposals Compare," Hedge Fund Law Report, Vol. 2, No. 18 (May 7, 2009); "AIFM Directive: Loosening the Regulatory Noose," Hedge Fund Law Report, Vol. 2, No. 24 (Jun. 17, 2009); "Andrew Baker, CEO of the Alternative Investment Management Association, Discusses the AIFM Directive, UK Tax, Short Selling and Other Topics with the Hedge Fund Law Report," Hedge Fund Law Report, Vol. 2, No. 29 (Jul. 23, 2009).

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Residence and Domicile

U.K. source income generally is subject to U.K. taxation regardless of the earner's residence or domicile. Generally, a natural person is considered "resident" in the U.K. for tax purposes if he is physically present there for at least half of the tax year or meets certain other tests relating to physical presence. A resident will be treated as non-domiciled (non-dom) if the U.K. is not his permanent home. For instance, a person who resides in the U.K. but was born elsewhere and frequently returns to that other country he will probably be considered a non-dom for U.K. tax purposes.

The significance of the distinction is that an individual who is both resident and domiciled in the U.K. will be liable for taxation on all his income from all sources worldwide (although the U.K. is a signatory of many treaties aimed at reducing double taxation.) A non-domiciled U.K. resident has a somewhat more favorable tax status in regard to overseas income, in that he may be taxed on a remittance basis (i.e., taxed on only such offshore income as has been remitted to the U.K.).

Due to changes in the law in 2008, a non-dom taxpayer seeking to be taxed on a remittance basis may have to pay £30,000 for the privilege (depending on the value of remittances and the length of residency). This remittance tax, combined with the new 50% tax rate, may work as a potent one-two punch for many successful hedge fund managers. As Timothy Spangler, a London-based Partner at Kaye Scholer LLP who chairs the firm's Investment Funds Group, stressed in speaking to the Hedge Fund Law Report, there are many resident non-doms in the financial services industry in London. "The best analogy I would give is Silicon Valley in California, where you have a large number of people from around the world who were attracted by a chance to be part of the high-tech industry." For hedge fund industry participants in London, the remittance charge, added to the 50% tax rate, is "an insult added to injury," Spangler said.

Press reports indicate that Guy Hands, founder and chairman of the private equity firm Terra Firma Capital Partners, has registered for non-domiciled status, and has moved his abode to Guernsey for tax purposes. If he continues to spend enough time in the U.K. to qualify as a resident, he will benefit from this move to the extent that remittance treatment proves enough of a savings to justify the £30,000 cost.

Individuals, Not Firms

Some observers believe that talk of a significant capital flight out of the U.K. is alarmist. Julie Patterson, Director of Authorised Funds and Taxation at the Investment Management Association, told the Hedge Fund Law Report: "The new income tax rate of 50 percent for the highest earners, for example, which goes into effect in April 2010, affects the individual earners, not the management firms. So there's no reason to expect that the personal tax rate will lead the firms to leave the U.K., even if some of their principals move to Guernsey."

On the whole, there is a consensus that there is and will continue to be some effect upon the expatriation of the fund management industry, both at the level of individuals and at the firm level. Some indicate for example that the 50% rate represents a psychological barrier – it is by definition the point at which one is handing over as much as one is allowed to keep. Timothy Spangler, of Kaye Scholer, suggested that "you'll have both the senior principals, like a Guy Hands, and entire businesses moving."

Furthermore, the consensus appears to be that taxation is a more serious spur to such flight than are the burdens of the EC Draft Directive as it now stands. Peter Astleford, a Partner with

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Dechert LLP and the head of their European Financial Services Group, compared tax considerations to the EC Draft Directive as potential spurs to expatriation as follows: "The proposed Directive as currently worded is, in many ways, quite a negative thing, but I don't think there will be a lot of change resulting from it for U.K. managers themselves: those who will be burdened if it goes through are, for example, potential investors, custodians, other types of funds and so forth." For example, the Directive would make delegation of custodial duties outside of the EU very difficult in practice, and within the EU it provides that such custodians, or "depositaries," must be EU incorporated credit institutions. Given this view of where most of the burden will fall, Astleford continued, "the big issue that might well drive hedge fund manager flight from the U.K. is taxation."

Change in Government

Grievances about excessive taxation were surely not assuaged on August 27, 2009, when Prospect magazine ran an interview with the chairman of the Financial Services Authority (FSA), Adair Turner, who said that aspects of the asset management industry have grown "beyond a socially reasonable size," and that it may be appropriate for the government to limit the size and influence of that industry through a tax on financial transactions, i.e., a "Tobin tax."

Lord Turner was speaking for himself, not for the Labour government, and the FSA does not set tax rates. Nonetheless, his remarks caused a stir. Jacqui Hatfield, a Partner in the London office of Reed Smith LLP, said: "The City is in a bit of an uproar about that."

By law, Prime Minister Gordon Brown must call a general election by June 2010. Polls indicate dissatisfaction with Brown's Labour government and the likelihood of a Conservative victory next year. This raises the question: would a Conservative government roll back the 50% tax, or otherwise create a more fund manager-friendly environment?

"For campaign purposes [the Conservatives will] try to say that they will abandon the 50% rate," said Hatfield. But she doubts that they will be able to do without it, simply because the fiscal circumstances the U.K. faces will not allow it. The U.K. Treasury anticipates a deficit of £175 billion pounds in the fiscal year that began in April 2009. With the acceptance of responsibility for failed banks, it had a debt burden of £800.8 billion, the highest such burden since the mid 1970s.

Astleford, like Hatfield, thinks such realities will likely keep the 50% tax rate in place regardless of the make-up of the new government. "Governments in general, including that of the U.K., have borrowed so much that it is very unlikely that any government or political party will be able to keep tax rates at current or lower levels."

Who Will Benefit?

If hedge fund manager flight (referring to firms rather than principals) does take place, what will be the most likely destination? Switzerland comes naturally to mind, since it is both conveniently located within Europe and outside of the EU, and since, as Hatfield said, "I think Switzerland is considered quite a nice place to go to. It has got its fair share of ex-pats." But some of those U.K. ex-pats, she found, have discovered that the cost of living in Switzerland is high, to a degree that cuts back severely on the benefit of the lower taxes.

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Another disadvantage is that for hedge fund management firms, a move to Switzerland would cause abandonment of the passporting rights that arise under EU single-market directives, both those already in place and those that will arise if the AIFM Directive is implemented in something akin to its present form. See "UCITS: An Opportunity for Hedge Fund Managers," Hedge Fund Law Report, Vol. 2, No. 27 (Jul. 8, 2009); "European Alternative Funds: The Alternatives," Hedge Fund Law Report, Vol. 2, No. 25 (Jun. 24, 2009).

Astleford said that to the extent there is and continues to be flight of management firms from London, there may not be any one geographic beneficiary. "Switzerland is getting a good deal of attention, but I don't think that country will be significantly more of a beneficiary than, say, Hong Kong, Singapore or the United States."

Spangler offered a concise answer when asked where the non-doms will go if the tax burden in London becomes prohibitive: "Home."

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