At A Glance

Transfer Pricing Solutions for UK Fund Management

Overview

Dramatic changes in market conditions have placed investment returns, management charges, and the fund management industry itself under the microscope. Tax authorities are likely to follow this trend and increase the already considerable level of scrutiny they apply to the industry's cross-border operations, including transfer pricing as a key item for review. While the most common transfer pricing issues encountered relate to the remuneration of core functions (such as fund management, investment research, commercial operations, and ancillary services), tax authorities also have examined compensation associated with the relocation of key activities. A number of related high-profile cases have attracted considerable publicity.

Further developments in the industry will compound these trends. The European Union's Markets in Financial Instruments Directive, for instance, is aimed at increasing transparency and competition within the EU market for investment services. Increased cross-border competition will heighten tax authority concerns about both the compensation paid to fund managers and the possible relocation of core functions. Greater transparency in the industry will allow more detailed analysis of what constitutes arm's length pricing between related parties in the industry.

The need to meet transfer pricing rules is far from the only concern facing the UK fund management industry. Non-resident funds must also ensure that the appointed UK-based investment fund managers receive arm's length remuneration in order to qualify for exemption from UK tax. Not being able to satisfy this requirement can result in a failure to meet the so-called Investment Manager Exemption (HM Revenue and Customs' (HMRC) revised Statement of Practice 1/01 ("SP 1/01")).

SP 1/01 outlines how, in assessing whether a UK fund manager has received arm's length remuneration, the UK tax authorities will be guided by the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. SP 1/01 further states that consideration must be given to the overall level of compensation received, taking into account the different forms in which the UK resident might be paid and anything that might serve to reduce compensation below an arm's length rate. It also states that HMRC's usual transfer pricing documentation requirements will apply, as outlined in HMRC's International Manual.

NERA's Capabilities

With specialist expertise and knowledge in Transfer Pricing for financial services companies, NERA is uniquely positioned to assist in-house practitioners and tax advisors in managing transfer pricing risk and to deliver value in this area. Our approach is differentiated by the following:

- An in-depth understanding of the industry and transfer pricing issues faced by the industry;
- The ability to determine how the value creation process impacts the remuneration that should be paid to different entities;
- Familiarity with advanced analytical techniques; and
- Access to a number of databases of information.

Insight in Economics™

NERA's relevant expertise includes:

- Establishing an arm's length basis for rewarding fund management activities, taking into account any provision of ancillary services;
- Providing an economic and financial analysis of the net compensation paid to a UK fund manager as part of a series of transactions;
- Analysing and providing economic advice on the overall system of transfer pricing adopted by an investment fund, and designing transfer pricing policies relating to the establishment of core and non-core activities;
- Drafting or helping to draft contemporaneous transfer pricing documentation in line with OECD Guidelines and UK requirements; and
- Providing specialist economics and finance input to support a taxpayer's filing position where a tax authority has raised an enquiry.

Client Experience

Hedge Fund and Transfer Pricing Enquiry

NERA was engaged by a hedge fund to assist in responding to enquiries raised by the UK tax authorities about transfer pricing. The aim of the study was to examine the remuneration received by UK entities that provide research and investment management services to the main fund manager, and to establish whether such remuneration was arm's length. A comprehensive value chain analysis was first conducted, which highlighted the importance of seed capital and intangible assets to the client's business. Data published by Mercer (a sister company of NERA) and other third-party data providers was then used to establish arm's length ranges for the different classes of assets under management and in the calculation of overall weighted averages. Adjustments were made to account for total assets under management using linear regression analysis.

Hedge Fund Reorganization

In a case involving the reorganization of a Swiss-based hedge fund, NERA was asked to determine both the remuneration attributable to investment research activities performed out of Switzerland and to value the transfer of the asset management company. NERA economists completed a comprehensive value chain analysis of the group and industry, which highlighted the important contribution of intellectual property. The ensuing economic analysis used different sets of third-party data to value the asset management company and the remuneration payable to the Swiss entity. Based on NERA's report, the company was successful in obtaining a ruling from the Swiss tax authorities.

Investment Management Group Documentation Study

NERA was retained by a global investment fund management group to establish the arm's length remuneration payable to a UK entity for providing investment management services. The first stage of the analysis was to derive an arm's length range for flat and total fees payable to the UK entity. NERA then combined market data from various sources, including its proprietary database of N-SAR filings, to determine a formula for splitting out performance fees from the total compensation that the UK entity should expect to receive. Regression analyses were used to adjust for the scale of assets under management. Further adjustments were made to accommodate differences in fund objectives and geographical scope.

Bank Asset Management Documentation Study

For the asset management arm of a leading European bank, NERA was asked to determine the remuneration of a Luxembourg-based fund manager with research and investment management subsidiaries in the UK and Switzerland. The approach relied on the use of market data in order to determine the remuneration of both the investment advisory and fund management activities. The remuneration was expressed as a function of the assets under management.

About NERA

NERA Economic Consulting (**www.nera.com**) is a global firm of experts dedicated to applying economic, finance, and quantitative principles to complex business and legal challenges. For over half a century, NERA's economists have been creating strategies, studies, reports, expert testimony, and policy recommendations for government authorities and the world's leading law firms and corporations. With its main office in New York City, NERA serves clients from more than 25 offices across North America, Europe, and Asia Pacific.

Contact

For more information or to contact our experts, please visit **www.nera.com/tp-ukfunds**.