

A quick look at the investment manager's exemption

Executive Summary

The Investment Manager's Exemption (IME) is a crucial tax relief that allows UK-based investment managers to manage offshore funds without creating a UK tax liability for those funds.

Without IME: Offshore funds managed from the UK would be subject to UK corporation tax on their profits

With IME: Funds remain tax-transparent in the UK, preserving their offshore tax status

Understanding and complying with the IME is absolutely critical for all UK AIFMs of offshore funds.

1. The fundamentals

The IME is a statutory relief that prevents UK investment managers from being treated as a "UK representative" of the offshore funds they manage.

Without this exemption, managing an offshore fund from London would make that fund liable to pay UK corporation tax on its profits, which would defeat the purpose of the fund being offshore.

2. Step 1: Is this "trading"?

The Trading Test

The IME only applies if the UK manager's activities constitute "trading." Here's what counts:

Usually trading:

- Active portfolio management with frequent transactions
- Managing hedge funds, private equity, or active strategies
- Any financial trade carried on by an offshore fund

Usually not trading:

- Pure investment holding (buy and hold forever)
- Passive index tracking with minimal rebalancing

3. Step 2: Are these “Investment transactions”?

Approved Investment Transactions

The law provides a specific list of qualifying transactions:

Qualifying Transactions:

- Stocks and shares
- Options, futures, and contracts for differences
- Loan relationships (bonds, credit facilities)
- Collective investment schemes (fund-of-funds)
- Other securities
- Foreign exchange transactions
- Certain cryptocurrency transactions

Non-Qualifying Examples:

- Direct property purchases
- Operating business activities
- Non-financial trading

4. Step 3: The five conditions checklist

To qualify for IME, you must satisfy ALL FIVE conditions:

Condition A: Investment Management Business:

Test: Was the AIFM carrying on investment management business at the time of the transaction?

Practical Check:

- Firm has proper FCA authorization
- Investment management is core business activity
- Transaction occurred while business was active

Condition B: Ordinary Course of Business :

Test: Was the transaction part of normal business operations?

Practical Check:

- Transaction fits within fund’s investment mandate
- Consistent with firm’s usual services
- Not a one-off or unusual arrangement

Condition C: Arm’s Length Relationship:

Test: Are the AIFM and offshore fund dealing independently at market terms?

Widely Held Funds:

- Fund is widely held within 18 months of launch, OR
- Being actively marketed to become widely held, OR
- Being wound up or dissolved.

Diversified Business:

- Services to this fund represent $\leq 70\%$ of manager’s total business (by fees)
- New managers get 18-month grace period
- Can exceed 70% if outside manager’s control and reasonable steps taken to remedy

Red Flags (likely fail test):

- Fund owned by manager’s shareholders

- Preferential fee arrangements
- Lack of proper fund documentation

Condition D: The 20% Rule :

Test: At least 80% of fund's income must benefit parties unconnected to the manager.

How It Works:

- Look at 5-year average (or fund lifetime if shorter)
- Connected persons = manager + related entities
- Must have <20% beneficial interest in fund's income

The test is satisfied if the AIFM intended to meet condition and took reasonable steps, but failed due to circumstances outside their control.

Practical Tips:

- Critical for fund launches and small funds
- Document efforts to raise third-party capital
- Consider seeding arrangements carefully

Condition E: Customary Remuneration

Test: Is the management fee at market rates?

Practical Check:

- Fees comparable to similar managers
- Standard industry terms (e.g., 2% management + 20% performance)
- No unusual discounts or premiums
- Proper benchmarking documentation

5. Common pitfalls and solutions

Start-Up Funds

Problem: New funds often fail Condition C (arm's length) and Condition D (20% rule) initially.

Solutions:

- Document active marketing efforts
- Use 18-month grace periods
- Implement proper governance structures
- Keep records of third-party outreach

Concentrated Investor Base

Problem: Fund dominated by few large investors may struggle with Condition D.

Solutions:

- Plan investor diversification strategy
- Consider seed capital arrangements
- Document efforts to broaden investor base

Related Party Issues

Problem: Manager-related entities investing in fund.

Solutions:

- Ensure arm's length terms for all investors
- Limit manager's economic interest
- Proper disclosure and documentation

6. Upcoming changes (2026)

On 28 April 2025, the government published draft legislation to amend the IME. The consultation closes on 7 July 2025 with implementation planned for 1 January 2026

Action Items:

- Review current arrangements against proposed changes
- Submit consultation responses by 7 July 2025
- Plan transition strategy for 2026 implementation

7. Critical actions

Check your documentation for each fund arrangement to make sure that you have, and maintain:

- Well-drafted investment management agreement
- Well-drafted fund documentation
- Fee benchmarking analysis
- Investor base analysis and marketing records
- Connected party analysis
- Transaction records and investment mandate
- HMRC condition compliance monitoring

8. What do you need to do now?

Our specialist team works exclusively in fund management and financial services. This means that we

can give you advice which is tailored to your needs and your business.

For example:

IME Compliance Reviews

- Comprehensive condition testing and documentation
- Risk assessment for existing fund structures
- Ongoing monitoring and compliance systems

New Fund Structuring

- Optimal offshore fund design for IME qualification
- Regulatory strategy and documentation
- Cross-border tax planning

2026 Transition Planning

- Impact assessment of upcoming legislative changes
- Restructuring advice to maximize benefits
- Strategic positioning for new rules

Get in Touch

With the significant IME reforms taking effect from January 2026, now is the time to review your fund structures and ensure continued compliance..

info@cummingspepperdine.com

+44 2030 623 340

www.cummingspepperdine.com

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