# EMERGING MARKETS INVESTMENT FUNDS

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Recent years have seen a substantial increase in investment in emerging markets such as the "Asian Tiger" economies, Eastern Europe and South America due to the rapid rates of growth of those economies. This has led to the launch of a large number of investment funds targeting emerging markets. Such investments are usually high risk but have the potential to generate higher returns than investments in developed nations.

Taxation is an important factor in establishing the structure of most investment funds, but this is particularly the case for funds investing in emerging markets as a number of such jurisdictions impose tax on capital gains made by foreign investors and have limited double taxation agreement networks. Where such countries have double taxation agreements, they may be based on the UN rather than the OECD model and may therefore permit greater taxation in the country of source than is usual in treaties between developed countries. As a result, it is often necessary to establish the fund vehicle (or a sub-fund) in a jurisdiction which has favourable double taxation agreements with the investment jurisdictions in question, rather than in a traditional tax haven. Countries with double taxation treaty networks tend to impose high rates of taxation. However, in a number of relatively high tax jurisdictions it is possible to set up fund vehicles which have the benefit of special low rates of tax on income and exemption from tax on capital gains, but which can benefit under those jurisdiction's double taxation agreements.

## UK Fund Vehicles

The UK has a comprehensive network of double taxation agreements, including agreements with many of the emerging markets currently targeted by investors. However, UK residents are generally liable to tax on capital gains, so a UK investment company would not be a suitable fund vehicle unless it qualified as an investment trust. If a company satisfies the conditions for approval as an

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investment trust under section 842 ICTA 1988, it will be exempt from tax on capital gains. The relevant conditions can be summarised as follows:

(a) The company must be UK resident (but need not be incorporated in the UK);

(b) each class of the company's ordinary share capital must be listed on the London Stock Exchange;

(c) no holding (i.e., shares or securities) in a company, or a group of companies, may represent more than 15% by value of the company's investments at the time of acquisition;

(d) the company's Memorandum or Articles of Association must prohibit the distribution as dividend of surpluses arising from the realisation of investments; and

(e) its income must consist wholly or mainly of income deriving from shares or securities, and it must not retain more than 15% of such income for any accounting period.

An investment trust investing in emerging markets may experience delays in repatriating income due to local exchange control restrictions, but this will not generally lead to a breach of condition (e) as subsection (2A)(a) of section 842 permits retention of income due to a restriction imposed by law.

In some cases, the relatively small number of suitable investments can lead to difficulties in complying with condition (c) which is designed to ensure investment diversification. The company will not breach the 15% condition merely because an investment rises in value after acquisition unless there is an addition to the holding. Bonus issues, but not rights issues, are ignored for this purpose. Particular care must be taken if the investment trust has a 51% subsidiary. Whenever money is owed by the subsidiary, or another group member, to the investment trust, the amount owed is treated as a security held by the investment trust and consequently as an addition to the holding in the company owing the money; this results in the need to revalue the investment trust's entire holding in the subsidiary and other group companies.

The investment trust's exemption from UK tax on capital gains makes it an attractive vehicle for investment in emerging market equities, as such funds generally seek to achieve high rates of capital growth rather than high income. An investment trust is liable to tax on income at normal UK corporation tax rates, so it may not be the best choice for a fund which will have a high income yield. Even for UK residents and those non-resident investors who are entitled to the whole or part of the tax credit on UK dividends, there is still some tax leakage as the tax credit is only 20% of the gross dividend and does not give credit for the entire corporation tax liability of the company. This is, of course, not a factor for UK corporate shareholders, as dividends paid by an investment trust comprise franked investment income and are not subject to corporation tax.

The relative tax-inefficiency of an investment trust compared to some other types of fund vehicle is more evident where income is not subject to significant rates of withholding tax at source. Levels of withholding tax may be reduced under a double taxation agreement and credit is available against UK tax for such withholding tax. Now that investment trusts can pay dividends as foreign income dividends ("FIDs"), problems of ACT surplus should no longer arise. However, FIDs are not a universal panacea as those shareholders who can recover the tax credit on an ordinary dividend cannot recover any tax credit on a FID. It is therefore necessary to consider the tax profile of likely investors in assessing the suitability of an investment trust as a vehicle for a high income fund.

Although the UK has the world's largest double taxation agreement network, its treaties with certain countries do not provide protection from tax on capital gains, e.g., those with India and China. If the fund will be investing predominantly in such a country and that country imposes tax on gains realised by foreign investors on the sale of shares in companies resident or incorporated there, the UK will probably not be the best choice of location for the fund vehicle. However, if such a country is only one of a number of investment jurisdictions targeted by the fund, it may be possible to channel investments in that country through a subsidiary or sub-fund resident in a country with a double taxation agreement which provides exemption from tax on capital gains in the target country. Investments in India are commonly channelled through Mauritius for this reason. However, care must be taken that the 15% rule is not breached, and it will be very difficult to do this if, to use the India/Mauritius example, the Mauritian company is a subsidiary and the Indian investments are likely to be more than 15% by value of the fund's portfolio. It may be possible to prevent the Mauritian company from being a 51% subsidiary or to ensure that the "holding" remains at a low value by structuring the investment so that the Mauritian company is financed in a way which does not count towards the "holding". Any such structure would, however, probably be complex and somewhat artificial. It has also been reported recently that the Indian taxation authorities have refused to give an advance ruling confirming that a Mauritian company which is a 100% subsidiary of a UK company will have the benefit of the dividend provisions of the India/Mauritius treaty. The refusal was on the grounds that the transaction was designed for the avoidance of tax, but the Advance Ruling Authority made some observations on the structure. In particular, they expressed doubt as to whether the Mauritian company was the beneficial owner of the Indian securities. However, it is understood that the Authority considered that the Mauritian company would have the benefit of the capital gains provisions of the treaty.

From a marketing perspective, investment trusts offer both advantages and disadvantages. They are familiar to investors, and the London Stock Exchange listing facilitates marketing of shares. The closed-ended nature of an investment trust is an advantage to its managers in view of the relatively illiquid nature of some emerging market investments, as they will not need to realise investments in order to satisfy redemptions. However, many investment trusts trade at a discount to net asset value, and this can deter investors from investing on the launch of a fund. This is why it is often necessary to offer "free" warrants to investors on the launch of an investment trust as an incentive to buy the shares on launch rather than later when they may be able to acquire them at a discount in the market.

From a taxation point of view, UK authorised unit trusts are very advantageous. They should have the benefit of the UK's double taxation agreements (although it is advisable in each case to check that the relevant treaty country, which may be unfamiliar with the concept of trusts, recognises the unit trust as entitled to benefit under the treaty) and, if properly structured, can provide investors with tax returns similar to those on direct investment.

Authorised unit trusts are exempt from UK tax on capital gains and are liable to tax on income at a rate of only 20%. An authorised unit trust is deemed to distribute all of its income available for distribution for each accounting period whether or not it actually makes distributions. These distributions can be treated in three different ways, according to the nature of the investments and the requirements of the unit holders. A unit trust investing mainly in bonds and other debt instruments will generally pay distributions in the form of interest distributions which are treated as if they were interest and are tax-deductible for the unit trust, reducing its UK corporation tax liability to nil. Such interest distributions are subject to deduction of tax at 20 % on payment to UK residents, and they are entitled to credit for such tax. Tax is also withheld on distributions to non-UK residents except to the extent that they are payable out of certain categories of eligible income (which includes certain investments the income on which would be paid gross to non-UK residents investing direct) or are paid to non-UK residents who have claimed the benefit of exemption from withholding tax under the UK's double taxation agreements. If the unit trust invests predominantly in equities, it is likely to pay foreign income dividend distributions, which are treated in the same way as FIDs. The ACT on the distributions can be recovered to the extent that the corporation tax liability is covered by foreign tax credits, and this prevents the accumulation of an ACT surplus in cases where dividends on the equities have suffered withholding taxes at source. An authorised unit trust invested in emerging markets might pay distributions as non-FID distributions if there are no significant withholding taxes levied on its income or its unit holders consist predominantly of investors such as UK pension funds and certain non-residents who are able to reclaim the tax credit on non-FID distributions.

Despite their tax advantages, authorised unit trusts are not frequently used for investment in emerging markets. A unit trust intending to invest in emerging markets may have difficulty in becoming authorised in view of the relatively high-risk nature of the investment and the fact that the unit trust manager and the trustee may not be able to agree that a market satisfies the criteria for investment under unit trust regulations. The illiquid nature of some underlying investments can cause problems for open-ended vehicles such as unit trusts as the managers may have difficulty in realising investments to satisfy redemptions. In the case of certain open-ended companies in other jurisdictions (including non-UCITS[2] companies in EC jurisdictions such as Luxembourg and Ireland), it is possible to reduce this problem by only permitting redemption at certain times and limiting the amount of shares or units which may be redeemed on any particular redemption date. A UK authorised unit trust is not able to do this.

Unauthorised unit trusts are liable to tax on capital gains unless the units are held only by persons who are exempt from UK capital gains tax for reasons other than non-UK residence. Therefore an unauthorised unit trust would not be suitable as a vehicle for investment by the general public, but it could be used for investment by UK exempt funds such as pension funds and charities. It would not be subject to any investment restrictions and would be able to restrict redemption of its units.

It is likely that open-ended investment companies (to be introduced in the UK in the next year or two) will be subject to regulatory and redemption restrictions similar to those of authorised unit trusts. They are therefore unlikely to become popular vehicles for emerging market investment, although they would be more familiar in form to overseas investors and should have the same tax advantages as authorised unit trusts.

## Traditional Tax Havens

The perceived advantage of establishing the fund vehicle in a jurisdiction which levies no taxation is that the fund vehicle is not liable to any tax in that jurisdiction and is not required to withhold tax from dividends paid to its shareholders. Such jurisdictions are therefore ideal for the types of investments which are not subject to any significant tax at source. Tax havens are, however, much less suitable in cases where the investment jurisdiction imposes tax on capital gains realised by non-residents or substantial withholding taxes on income. A fund vehicle in a traditional tax haven does not have the benefit of a network of double taxation agreements to protect it against such taxes, and the shareholders in the fund vehicle are not generally entitled to any credit for underlying taxes against their own tax liability on the dividends which they receive from the fund vehicle or their gains

[2] i.e., companies which do not comply with the European Community Council Directive of 20th December 1985, (Undertakings for Collective Investment in Transferable Securities ("UCITS") 85/611/EEC).

on disposal of their shares. The channelling of their emerging markets investments through a tax haven company can have the effect of reducing their net return.

Some emerging market funds have established the main fund vehicle in a tax haven but have channelled the fund's investments in countries which levy tax on capital gains through a sub-fund in a country which has the benefit of double taxation agreements. As mentioned above, Mauritius is commonly used as a location for investments in India, and Cyprus is a popular location for investments in Eastern Europe and the countries of the former Soviet Union. As explained below, in both Cyprus and Mauritius it is possible to set up an investment company which pays a very low rate of tax but has the benefit of the country's double taxation agreements.

If an open-ended investment fund is to be marketed in the UK, it will usually be advantageous for it to qualify for "distributor" status under the UK "offshore funds" legislation to prevent UK investors suffering a charge to income tax on gains.[3] Closed-ended companies are no longer within the offshore funds regime.[4] In order to qualify for distributor status, the fund must distribute substantially all of its income. If the fund is likely to suffer protracted delays in repatriating its income, care should be taken to ensure that it will be able to pay dividends of the required amount within six months after the end of the accounting period. The Inland Revenue have a discretion to grant an extension. The fund must also satisfy certain investment diversification requirements, including a requirement that no more than 10% by value of the assets of the fund may consist of interests in a single company. An offshore fund which channels a substantial part of its investments through a sub-fund would at first sight appear to be in breach of that investment restriction, but sub-funds which are wholly-owned subsidiaries are generally "looked through" for the purpose of ascertaining whether the offshore fund satisfies the investment conditions. The income and assets of the sub-fund are treated as those of the main fund, and payments between the fund and the sub-fund are disregarded. Therefore the use of a wholly-owned subsidiary as a sub-fund will not generally prejudice the fund's ability to obtain distributor status.

If the main fund vehicle is an open-ended company or unit trust, it will be necessary to ensure that any sub-fund is also open-ended and has similar redemption terms so that the main fund will be able to redeem shares or units in the sub-fund when it receives redemption requests from its own investors. Mauritian companies can be either closed-ended or open-ended. Company law in Cyprus does not currently permit the establishment of open-ended companies (although shares may be redeemed out of share premium account), but legislation is being prepared which, if implemented, would permit them. In practice it is still

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[3] Sections 759 to 764 and Schedules 27 and 28 ICTA 1988.

[4] Section 759(1) ICTA 1988.

possible to establish a Cyprus company as the sub-fund of an open-ended fund vehicle by restricting the share capital of the Cyprus company to a nominal amount and by the fund vehicle providing most of the sub-fund's capital by subscribing for participating loan instruments. When the fund vehicle receives a redemption request, it redeems part of its holding of participating loan in the sub-fund and receives an amount equivalent to what it would have received had the Cyprus company been open-ended.

**Low Tax Vehicles in High Tax Jurisdictions**

Luxembourg SICAVs (sociétés d'investissement à capital variable) are frequently used as international investment funds. Although they are open-ended companies, it is possible to structure them so as to restrict redemption to certain valuation dates and impose a restriction on the percentage of the total shares in the company which may be redeemed on any particular valuation date. They are therefore a better choice for relatively illiquid investments than UK unit trusts and certain other open-ended vehicles. Luxembourg holding companies established under the 1929 legislation are expressly excluded from the benefit of Luxembourg's double taxation agreements. Whether SICAVs and other tax-exempt Luxembourg funds qualify for the benefit of double taxation agreements will depend on the interpretation of the treaty in question. It is understood that SICAVs are not generally entitled to benefit under the treaties.

The Republic of Ireland is becoming increasingly popular as a jurisdiction for the establishment of both fund vehicles and fund management companies. Management companies established in the International Financial Services Centre in Dublin are liable to tax at the reduced rate of 10%. There are a variety of types of company and unit trust which qualify for complete, or virtually complete, exemption from Irish tax; some of these are open-ended and some are closed-ended. Certain professional-only funds require a minimum investment of IR£200,000, while others permit smaller investment but impose stricter investment restrictions. Ireland has a broad network of double taxation agreements, and tax-exempt funds are not usually expressly excluded from benefit. It will be a matter of interpretation of each treaty whether a tax-exempt fund will be able to benefit from the treaty despite the fact that it is not liable to tax in Ireland; it is understood that, in practice, some emerging market jurisdictions may allow funds of this sort to benefit under Ireland's treaties. Like Luxembourg, Ireland is a jurisdiction which is becoming familiar to investors and is commonly used as the location for the main fund vehicle.

Cyprus, on the other hand, tends to be used mainly as a location for sub-funds. It would not be possible under current Cyprus company law to establish a fully open-ended company in Cyprus although, as mentioned above, this may soon become possible. It is best known as a route for investment in Eastern Europe and the countries of the former Soviet Union in view of its favourable treaties with those countries. A Cyprus offshore company is liable to tax on income at a special reduced rate of 4.25%, is not taxed on capital gains and does not withhold tax on dividends. It is generally entitled to the benefit of Cyprus' double taxation agreements. The beneficial owners of the shares in the offshore company must not be resident in Cyprus, and the company must not conduct its business activities in Cyprus or receive income from Cyprus sources, although it may receive interest on Cyprus bank accounts. In many cases, the company's tax liability can be virtually eliminated once management and other expenses are deducted and credit is given for withholding taxes suffered in the investment jurisdictions. As Cyprus offshore companies are not liable to tax on capital gains they are particularly suitable for funds investing for long-term capital growth which have low income yields. Cyprus may, however, not be the best choice of jurisdiction for funds which are trading in securities, as the Cyprus tax authorities may seek to characterise the gains arising on such transactions as income and therefore subject to tax at 4.25% (which would not be the case if the gains were capital).

Malta is currently seeking to establish itself as a financial services centre[5]. Although Maltese investment companies are subject to Maltese corporation tax, both resident and non-resident shareholders who receive dividends from the company can reclaim tax credits. Malta has not yet become a tried and tested investment funds jurisdiction, but it may become more frequently used in future.

Mauritius has already been mentioned.[6] It is used as the jurisdiction of incorporation and residence either of a sub-fund or of the main fund vehicle, but if the Indian authorities establish a practice of denying treaty benefits to Mauritian sub-funds of non-Mauritian parents, it may become more usual for the main fund vehicle of Indian funds to be established in Mauritius. Mauritius has a new double taxation agreement with China and is likely to become a popular route for investment into China as well as India. At present, Mauritian offshore companies can elect to pay tax at a particular rate (usually a rate slightly in excess of their overseas tax credits) to reinforce their entitlement to benefit under Mauritian double taxation agreements. It is understood that the Mauritian Income Tax Act 1995 has imposed a 15% fixed rate of tax on income of offshore companies incorporated after 1st July 1998 to help counter possible arguments from treaty partners that such companies are not liable to pay tax in Mauritius.

Hungary has recently established an offshore company regime; such companies have the benefit of greatly reduced rates of corporation tax and withholding tax on dividends, but also have the benefit of Hungary's double taxation agreements

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5 See the article 'Malta: an Emerging Offshore Centre' in Issue 3 of Volume 4 of *The Offshore Tax Planning Review*.

6 See also the article 'Mauritius and other Routes for Direct Investment into India' in Issue 1 of Volume 5 of *The Offshore Tax Planning Review*.

which include agreements with India and a number of other emerging markets. It remains to be seen whether they will be suitable for use as investment fund vehicles.

## Summary

In deciding where to locate the fund vehicle, it is necessary to start with the taxation regime of the investment jurisdictions and work backwards. If such jurisdictions do not impose tax on capital gains of non-residents (or high withholding taxes on income in the case of a high income yielding fund), the fund vehicle can be resident in a traditional tax haven. If the investment jurisdictions do impose high taxation on the fund's gains or income, either the fund or a sub-fund should be resident in a treaty jurisdiction but should be an entity which qualifies for very low rates of taxation and does not have to withhold tax on dividends. There is an increasing availability of such entities as countries climb on the international business centre bandwagon. Split-level structures can provide flexibility, allowing shareholders to invest in a familiar structure such as an investment trust or a Luxembourg SICAV while obtaining the benefit of double taxation agreements which would not be available to the main fund vehicle. However, split-level structures are potentially open to attack on the basis of treaty-shopping or substance over form. Detailed advice should be obtained on the effect of the relevant double taxation agreements and how they are applied in practice by the investment jurisdictions. Some emerging market jurisdictions are politically unstable, and their taxation laws and practice are sometimes difficult to ascertain and not always consistent.