

## **Expanding the Investment Transactions List for the Investment Management Exemption and other fund tax regimes**

### **Response to Consultation by Simmons & Simmons LLP**

#### **1. Introduction**

- 1.1 Simmons & Simmons LLP welcomes the opportunity to submit its formal response to the consultation entitled “Expanding the Investment Transactions List for the Investment Management Exemption and other fund tax regimes” (the “**Consultation**”).
- 1.2 Simmons & Simmons LLP is a leading international law firm with offices in major business and financial centres throughout Europe, the Middle East and Asia. Our experience in relation to fund management involving digital assets was most recently recognised at the Hedgeweek European Digital Assets Awards 2022 where we were awarded ‘Best Law Firm – Overall’.
- 1.3 We are supportive of the principles and purpose of the Consultation to include cryptoassets within the scope of the UK’s Investment Manager Exemption (the “**IME**”) and believe the proposed extension would meet a pressing need for many new and established alternative investment fund managers.
- 1.4 Given the breadth of the matters covered in the Consultation, we have sought to focus on the high-level principles behind the proposals and to outline our preferred approach to the aspects that deal with reform of the IME, rather than responding to each of the specific questions raised in the document. We have tried where possible to group our comments under the headings set out in the Consultation for ease of review. We refer to cryptoassets and digital assets interchangeably in this response, and no implications should be drawn from the use of a particular term in any specific context.
- 1.5 We would be happy to participate in further discussions on the reforms considered in the Consultation, including the drafting of relevant regulations to make the necessary changes to the IME ITL in due course.

#### **2. Overview**

- 2.1 As background, the scope of the IME, and the extent to which it may encompass certain forms of cryptoasset, has been a regular subject of dialogue with our clients in recent years. The IME is an important factor in the UK being an attractive jurisdiction from which to manage alternative investment funds. However, the current lack of clarity regarding the treatment of cryptoassets under the IME has caused and is causing investment managers to consider other jurisdictions as a location from which to deploy investment strategies involving cryptoassets, where those jurisdictions may provide greater certainty of treatment for funds and their investors. As a consequence, we have seen an increase in managers establishing or extending their presence in other jurisdictions, including the UAE and the Cayman Islands. These are points we have raised with HMRC in previous discussions on the issue.
- 2.2 Therefore, HMRC’s launch of the Consultation is highly welcomed, particularly in an environment where many tax authorities worldwide in jurisdictions where fund managers have traditionally been domiciled are struggling both to 1) accommodate managers who seek to invest in digital assets on behalf of their fund and other clients, and 2) provide clarity on how existing tax rules, such as the IME in the UK or similar measures such as the “trading safe harbors” in the US, apply to such activities.

- 2.3 Before getting into the detail of our comments, we consider it helpful to identify certain key principles that should in our view underpin any reform of the Investment Transactions List (the “ITL”) for IME purposes and for the purposes of other UK fund tax regimes as follows:
- (A) as to the preferred approach, we favour making the changes to the ITL for IME purposes first, with any changes to the ITL for other UK fund tax regimes following as a second phase.
  - (B) we suggest that amendments to the ITL for IME purposes are made by way of HMRC regulations as permitted under existing primary legislation governing the IME, rather than through the introduction of new primary or secondary legislation. Taking this approach would enable those managers who would most welcome the changes to the ITL (i.e. UK based managers managing non-UK funds investing in digital assets and who wish to rely on the IME) to benefit from the reforms at pace.
  - (C) there are broader considerations, in particular regulation, that currently affect the ability of UK domiciled funds to invest in digital assets, and therefore it may be more prudent to align developments to the tax regime for such UK funds with any changes to the regulatory framework in due course as a second phase of reform, rather than either delaying reform of the IME ITL or having the tax regime “front run” what may be permissible as a matter of regulation.
- 2.4 Tax and finance authorities in jurisdictions such as the US, Singapore and Hong Kong are currently considering how best to address the position of managers in those domiciles that wish to invest in digital assets on behalf of their non-resident fund and investor clients. If the UK acts now and effectively, such a move would achieve ‘first-mover’ advantage, with the UK potentially being a model for how other jurisdictions might wish to proceed.
- 2.5 As a final opening remark, whilst we note the continuing volatility in respect of certain digital assets, we do not see that this is affecting clients’ interest in strategies involving digital assets, or in the proposed reform of the IME to encompass such assets. Indeed, for many fund managers, the current market conditions present an attractive opportunity to generate returns which they would be keen to capitalise upon, were the IME position clearer.

### 3. Defining Cryptoassets

#### ***Basic definition***

- 3.1 We are generally in favour of HMRC adopting the definition proposed in the “Crypto-Asset Reporting Framework” (“**CARF**”) published by the Organisation for Economic Co-operation and Development (“**OECD**”) in March 2022. The proposed approach of a broad, principles based definition of relevant digital assets aligned with international standards is sensible.
- 3.2 Our response proposes that HMRC should provide the necessary degree of clarity and futureproofing to accommodate developments in the digital assets ecosystem. Whilst we appreciate that the CARF definition is still subject to change, we recommend that the reforms to the IME ITL should not be delayed until that definition is final. In such circumstances, there are other definitions, such as that applying for AML purposes<sup>1</sup>, which could be readily adopted as an alternative starting point.
- 3.3 We note that as with the position for conventional investments under the existing IME ITL, the definition should define the in-scope digital assets themselves, rather than the types of transaction that are being undertaken in such assets. It should be made clear (potentially via supplementary guidance or the explanatory memorandum accompanying any

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<sup>1</sup> Regulation 14A(3) Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (SI 2017/692)

regulations) that transactions such as lending, staking or market-making in respect of relevant digital assets are within the scope of the amended IME ITL.

### **Exclusions**

- 3.4 In principle we can understand why HMRC may wish to introduce certain additional exclusions, given the breadth of the CARF definition. However, we consider that rather than seeking to adopt exclusions for broad classes of cryptoasset, which may restrict both current and future investment opportunities, it would be preferable for any such exclusions to be narrowly drawn. In addition, it seems to us that the justification for any exclusion should be whether the underlying transaction or conventional asset or instrument to which the digital assets relates would be expressly excluded from the scope of the current IME ITL, as set out in the Investment Manager (Investment Transactions) Regulations 2014, which in turn adopt (with certain modifications) the categories of transaction defined under regulation 2 of the Investment Transactions (Tax) Regulations 2014 (SI 2014/685) (“**ITT Regs 14**”).
- 3.5 In general, taking this approach would provide greater certainty around the scope of any exclusions that were adopted, enabling managers to make use of their experience in dealing with the IME in the context of conventional asset classes, and would make clear that the intention of the exclusions is to prevent circumvention of the current IME ITL through the use of digital assets, rather than to treat digital assets differently as a matter of principle.
- 3.6 We note HMRC in the Consultation suggests that it would want to exclude:
- (A) transactions in land, including transactions of any nature which result in the acquisition of land;
  - (B) cryptoassets that provide for the transfer of tangible assets or intangible assets not already included in the ITL; and
  - (C) closed-loop cryptoassets which are only intended for use within a closed permissioned network.

Our observations in respect of each of these proposed exclusions are as follows:

### **Transactions in Land**

- 3.7 In principle, we consider the exclusion from the ITL of digital assets relating to transactions in land to be a reasonable approach subject to the comments below.
- 3.8 We note that under the current IME ITL, derivative contracts which relate to or reference a broad based index of land of the type contemplated in regulation 3(2) of the ITT Regs 14 are not excluded, thus permitting land related derivatives based on, for example, the performance of a relevant Investment Property Databank index. Similarly, therefore, cryptoassets which offer comparable economic exposure to land index-related derivatives should not be excluded from the IME.
- 3.9 Although not specifically a matter covered in the Consultation, we note that discussions have previously taken place concerning whether transactions in non-UK land should be permitted within the IME ITL. To the extent that the UK decided that it did not wish to retain UK taxing rights in respect of profits arising from non-UK land through an extension to the IME, digital assets representing such non-UK land should similarly be brought within the scope of the IME ITL.

***Cryptoassets that provided for the transfer of tangible assets or intangible assets not already included in the ITL***

- 3.10 We appreciate HMRC may consider that cryptoassets which involve the *transfer* of tangible assets should be excluded, based on a concern that including such cryptoassets might lead to a reduction in tax receipts. However, we see no justification to restrict the definition by reference to the potential delivery of a tangible asset – as with conventional derivative contracts such as options, futures and contracts for difference<sup>2</sup>, we consider that the exclusion of a relevant digital asset from the IME should only operate if and to the extent that delivery of the underlying asset actually occurs, in circumstances where the asset itself does not fall within the IME ITL.
- 3.11 Technically speaking, it is often the case that an asset underlying an option or future contract that is within the scope of the existing IME ITL, such as a precious metal, could be physically delivered on the expiry date of that contract; however, the practical reality is that investment managers acting in the ordinary course of business and operating in these markets will take steps to prevent delivery actually occurring, for example by arranging for the contract to be cash-settled or rolled over.
- 3.12 Extrapolating the approach under the existing IME ITL from derivatives to cryptoassets would provide the necessary flexibility to investment managers to continue operating in a comparable way with minimal to no risk of circumvention of tax, as where assets were physically delivered, the revised IME ITL could provide that the transaction involving the relevant digital asset was excluded from the scope of the IME. As noted above, managers would be able to use their experience gained in respect of derivative contracts when transacting in digital assets with equivalent underlying tangible assets.
- 3.13 As regards digital assets that relate to intangible assets, including potentially non-fungible tokens (“**NFTs**”), we are not clear as to the rationale for such NFTs to be excluded as a matter of course. We are concerned that taking the approach proposed in the Consultation to exclude cryptoassets that provide for the transfer of intangible rights not themselves covered by the existing IME ITL could inhibit the development of investment strategies, either now or in the future, despite it being clear that the purpose of those strategies was to generate a financial return, rather than to acquire ownership of the relevant intangible assets.
- 3.14 Instead, we consider that the other conditions of the IME, in particular the requirement that the investment manager is an investment manager acting in the ordinary course of its investment management business, should operate to protect the UK tax base and to provide a clear boundary between circumstances where the IME should be available and other situations where it should not.

***Closed-loop networks***

- 3.15 We understand that HMRC proposes to exclude tokens available via closed-loop networks, although the Consultation is somewhat unclear as to whether all such tokens are proposed to be excluded or only those which are used for the purposes of purchasing goods or services from the issuer or participants on the network in question.
- 3.16 Whichever is the correct interpretation, we consider that HMRC will have difficulties defining ‘closed-loop networks’, and secondly, to adopt this exclusion could inadvertently exclude cryptoassets invested into through networks which have been or will in the future be set up to give greater certainty regarding transactions and counterparties. By way of example:

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<sup>2</sup> as defined respectively in ss.580, 581 and 582 of Corporate Tax Act 2009

- (A) certain networks have been or are being established where participants must meet stringent anti-money laundering checks – could the limitations on the participants in such networks be viewed as creating a closed-loop network for certain transactions;
- (B) financial institutions are setting up decentralised finance or DeFi liquidity pools that generally only professional investors can access – on one level, these could be considered a closed-loop network; and
- (C) financial institutions are developing digital tokens to send payments which operate on a closed network due to concerns surrounding commercial stablecoins as evidenced recently by TerraUSD and Luna’s collapse<sup>3</sup> - again, it would seem inappropriate for such tokens to be excluded simply due to their being hosted and invested in through a closed network.

3.17 Instead of seeking to carve out or specifically exclude closed-loop networks, we propose again that the existing conditions of the IME, in particular that the investment manager is an investment manager acting in the ordinary course of its investment management business, should provide appropriate protection to the Exchequer without requiring an overly broad exclusion for digital assets on closed-loop networks.

3.18 We also note that in the context of the CARF, the exclusion of closed-loop cryptoassets is intended to reduce the reporting burden on relevant service providers. Whilst the exclusion makes sense in this context, it does not in our view follow that such cryptoassets should generally be excluded as relevant cryptoassets for the purposes of the amended IME ITL, in circumstances where an investment manager is entering into relevant transactions as agent of a relevant fund or managed account.

#### 4. **Process for amending the IME ITL**

4.1 As noted above, we strongly recommend the amendments to be adopted by introducing a new category of “relevant cryptoasset” which is specified through HMRC regulations for the purposes of sections 827 and 835S of the Income Tax Act 2007 (which apply for income tax purposes) and section 1150 of the Corporation Tax Act 2010 (which applies for corporation tax purposes).

4.2 As well as enabling the relevant changes to the IME ITL to be made without the need for Parliamentary approval (whether through primary or secondary legislation), a further attraction is that these sections enable the making of regulations which have effect in relation to the tax year (for income tax purposes) or accounting periods (for corporation tax purposes) current on the day on which the regulations are made.

4.3 HMRC should make full use of the *vires* provided to it under these sections to amend the IME ITL, retroactive to 6 April 2022 for income tax purposes or the start of the current accounting period of a person who would otherwise be within the charge to corporation tax. This would broadly align with the timing of the Economic Secretary’s statement at the Innovate Finance Global Summit on 4 April 2022 and would underline the government’s intent as set out in that statement.

#### 5. **The ITL for other UK fund tax regime purposes**

5.1 As noted above, in our view the primary focus should be for HMRC to amend the IME ITL as soon as practicable through the making of relevant HMRC regulations, as this meets an immediate need of UK based investment managers who are already permitted to undertake such transactions on behalf of relevant non-resident funds and managed accounts.

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<sup>3</sup> <https://www.bloomberg.com/news/articles/2022-05-19/luna-terra-collapse-reveal-crypto-price-volatility>

5.2 With regard to amending the ITT Regs 14, which sets out the ITL for other UK fund tax regime purposes, we are not yet persuaded that there is such an immediate requirement given ongoing discussions concerning the UK regulatory treatment of digital assets. We therefore suggest that changes to the ITL that applies for non-IME purposes that would require secondary legislation amending the ITT Regs 14 could follow and support relevant regulatory developments, rather than front-running these.

6. **Contact details and next steps**

We would welcome the opportunity to further discuss any of the points raised in this response. If you wish to do so, please contact Martin Shah, Partner, Simmons & Simmons LLP, at [martin.shah@simmons-simmons.com](mailto:martin.shah@simmons-simmons.com) or on 020 7825 4638.

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