

Analysis

The Government amendments to domestic Permanent Establishment rules

Speed read

The UK Government has published draft legislation to modernise its Permanent Establishment rules and statutory Investment Manager Exemption. The widened definition of ‘dependent agent’ permanent establishment and narrowed agent of independent status exemption may bring more non-resident funds and family offices within the UK tax net. The Investment Manager Exemption is also being amended; the repeal of the ‘20% rule’ is welcome, simplifying compliance for many investment managers. However, increased scrutiny on the ‘independent capacity’ test may create fresh challenges for some structures. The reforms are open for consultation until July 2025.



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On 28 April 2025, the UK government published draft legislative amendments to update the UK’s domestic tax rules on permanent establishments (PE) and modernise the Investment Manager Exemption (IME). These changes follow a 2023 consultation and extensive engagement with industry stakeholders, reflecting a recognition that the UK’s existing PE and IME rules – some over 20 years old – have fallen out of step with the realities of the asset management sector.

The legislative amendments

The draft legislation published on 28 April amends the statutory definitions of permanent establishment and agents of independent status to more closely align the UK’s domestic definitions to the drafting of Article 5 of the Model Tax Convention on Income and on Capital published by the OECD on 21 November 2017 (‘the 2017 OECD Model Tax Convention’). In particular:

- **Widening of the ‘dependent agent’ PE definition:** CTA 2010 s 1141(1)(b), which defines a ‘dependent agent’ PE, is amended so that a PE arises where a person acting on behalf of a non-resident company ‘habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts, that are routinely concluded without material modification by the company’. Notwithstanding the Government’s position that the amendments do not expand the existing domestic definition (which, in their view, was already broad in scope), it appears likely that the new domestic rule can result in a larger number of previously out of scope arrangements being considered UK PEs; for asset managers, there is a specific concern that certain advisory structures may lead to the recognition of a UK PE under the new rules.
- **Narrowing of the exemption for agents of independent status:** The exemption for agents of independent status (the AIS exemption) in CTA 2010 s 1142 is also narrowed so that independence is precluded where the agent acts exclusively or almost exclusively for one or more companies to which it is ‘closely related’ (defined in CTA 2010 new s 1143(2AC) as two persons under common control or meeting a 50% investment condition).

The draft legislation also amends the UK rules dealing with attribution of profits to PEs in the CTA 2009, clarifying that the OECD’s Commentary on Article 7(2) of the 2017 OECD Model Tax Convention and relevant OECD guidance and guidelines can be used to interpret the separate enterprise principle. Domestic rules which previously sought to codify these principles are repealed.

Additionally, the government published draft legislation and guidance amending the IME. The IME is a cornerstone of the UK’s asset management industry, providing certainty that non-resident funds can appoint UK-based investment managers without triggering a UK tax charge on trading profits, provided certain conditions are met. In its consultation responses, the government recognises that the proposed amendments to the UK’s domestic definition of ‘dependent agent’ PE ‘will place greatest strain on the Investment Manager Exemption’. In response to feedback, the Government has proposed a number of reforms to the IME, some of which are very welcome. These include:

- **Repeal of the ‘20% rule’ (Condition D in CTA 2010 s 1146(6)):** Previously, the IME was unavailable where a UK investment manager and connected persons were entitled to more than 20% of the non-resident’s profits over defined periods, and could not demonstrate that the failure to maintain their entitlement to the non-resident’s profits below 20% was attributable to matters outside of their control (the so-called ‘intention’ component). This rule is repealed, along with the partial charging provision in CTA 2010 s 1149.
- **Clarification that the IME is a statutory safe harbour and not an exclusive alternative to the general exemption:** The ‘if (and only if)’ construction in s 1146 is repealed, so that the IME is now expressly an interpretation of the general agent of independent status exemption, not an exclusive provision. If the IME is not met, the general exemption may still technically be available.
- **Broadening of the ‘investment transactions’ list:** The new definition in CTA 2010 s 1150 is exclusionary and, therefore, wider; though transactions relating to UK

land and physical commodities remain specifically excluded. However, the definition is limited to investment transactions 'made by an investment fund'. There is a concern that this proposed drafting would exclude non-residents that do not meet the regulatory definitions of an investment fund.

The government also published a revised draft of Statement of Practice 1 (2001): treatment of investment managers and their overseas clients (SP 1/01). The most significant changes relate to the application of the 'independent capacity' test (Condition C of the IME):

- The 'widely held' safe harbour has been extended so that a non-resident that is a 'qualifying fund' under FA 2022 Sch 2 para 9(1) can now demonstrate independence, regardless of whether it is widely held (paragraph 46 of the draft SP 1/01).
- There is new, stricter guidance on what is required for a fund to be actively marketed: 'Operating on a business-as-usual basis with an expectation that the position will rectify itself is not sufficient' (paragraph 49 of the draft SP 1/01).
- The substantial services safe harbour in respect of Condition C has been restricted to 50% rather than 70% (paragraph 51 of the draft SP 1/01); the guidance suggests that the change aims to ensure that the IME does not apply to funds which are not genuinely independent (although the choice of 50% appears arbitrary – more on this below).

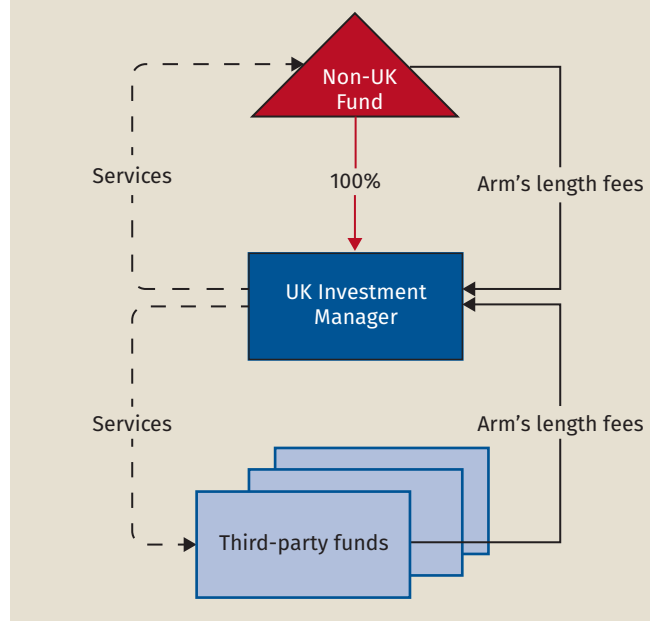
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Winners and losers

The proposed amendments to the IME are certainly encouraging for a number of UK investment managers that have struggled over the last few years with the compliance strain and uncertainty created by the '20% rule'. In particular, the growth and success of the multi-manager industry and rise of algorithmic and machine learning strategies had pushed investment managers towards a technical and commercial 'Catch-22': external investors require manager capital invested in the fund to show alignment of interests and proof that managers do not have an incentive to inflate costs, but funds have become increasingly capacity-constrained, limiting their ability to scale and deploy additional external capital without lowering returns. For those managers, the repeal of the '20% rule' is expected to materially simplify compliance with the IME.

However, not everyone is expected to be positively affected by the proposed legislative amendments. Of particular concern is the narrowing of the AIS exemption. Under current law (both domestic and in international treaties), a non-resident (even if they cannot access the IME) will not be regarded as having a PE in the UK because it carries on business in the UK through 'an agent of independent status acting in the ordinary course of the agent's business'. Independence is largely analysed by reference to economic, legal and commercial parameters; a UK manager that is paid arm's length fees for the services it provides to a non-resident, and that is functionally and operationally distinct from the non-

Figure 1: No IME – no investment transactions

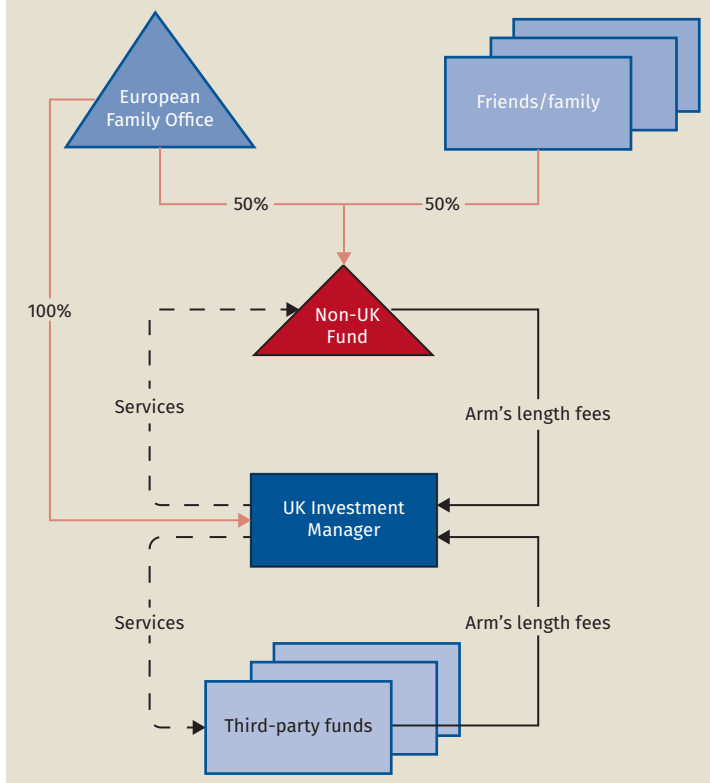


resident, has generally been able to rely on the general domestic or international treaty AIS exemption.

Under the draft legislation, for UK domestic purposes (at least if and until the UK renegotiates its international treaties), certain structures that previously could have relied on the AIS exemption would seemingly fall outside its narrower scope. Take the example of a non-resident fund that does not carry out 'investment transactions' (even within the new, broader definition) and uses the services of a wholly owned, but independent, UK investment manager that is paid arm's length fees and provides investment management services to other third-party funds (see figure 1).

The IME would not be applicable, on the basis that the non-resident fund does not carry out 'investment transactions'. The 'if (and only if)' construction would not prevent the UK investment manager from relying on the AIS exemption, as it does not carry out 'investment transactions' on behalf of the non-resident fund. The repeal of the '20% rule' would not help this non-resident. Under current law (i.e. both the domestic and international AIS exemption), it would be possible to get comfortable that the UK investment manager is an agent of independent status, on the basis that it is paid arm's length fees for the services it provides to the non-resident, it provides similar services to other third-party funds and it is distinct (functionally and operationally) from the non-resident. Following the proposed amendments to the UK domestic exemption in CTA 2010 s 1142, the UK manager would have to successfully demonstrate that the services it provides to third-party funds are a significant enough part of its business; this is because independence under the AIS exemption is precluded where an agent acts 'exclusively or almost exclusively' on behalf of the non-resident fund (or persons connected to the non-resident fund). A similar issue is likely to arise in the context of family office structures, which may wholly own a UK investment manager whilst also anchoring a non-resident fund that is managed by the UK investment manager (being paid arm's length fees). See figure 2 overleaf.

Figure 2: Family office structure



It remains to be seen whether the UK Government will seek to include the amended PE definitions in its international treaties. For the time being, the amended domestic AIS exemption is narrower than that currently adopted by the UK in its international tax treaties; there is therefore a question as to whether funds structured in treaty jurisdictions would maintain an advantage by relying on the treaty exemption rather than the UK domestic exemption (at least if and until such treaties are amended in line). When establishing new structures, choosing established treaty jurisdictions such as Ireland or Luxembourg may provide more flexibility – giving access to local talent pools and infrastructure, optionality between the domestic and treaty path to exemption for investment managers, access to political counterweight through a jurisdiction looking to retain taxing rights in accordance with their treaty with the UK (including through the Mutual Agreement Procedure).

Independence day: the new stress test?

Should the ‘20% rule’ be abolished, if one of the remaining IME conditions are failed, all trading income attributable to the UK PE of a non-resident fund (including income arising from third-party capital unconnected to the manager) would become chargeable to UK tax. In the past, HMRC have often been focused on the ‘20% rule’; its removal raises the question of which condition HMRC will focus on moving forward. It may place increased scrutiny on the ‘independent capacity’ test (Condition C). It is unclear how this increased scrutiny will play out in audits and enforcement actions.

The conditions to meet the ‘independent capacity’ test are currently largely found in SP 1/01. The Government is continuing with this approach, as the revisions to the scope of the ‘independent capacity’ test are found in amended paragraphs 44–55 of SP 1/01 rather than the

draft statutory amendments.

Reliance on SP 1/01 has generally been viewed favourably, as it provides both HMRC and taxpayers with flexibility; however, in light of the recent adverse judicial treatment given to HMRC guidance by the Court of Appeal in *HMRC v BlueCrest Capital Management (UK) LLP* [2025] EWCA Civ 23, the fact that the ‘independent capacity’ test continues to rely heavily on nonbinding guidance in its application may fail to provide taxpayers with the degree of certainty that the reform is meant to achieve.

Looking specifically at the amendments to the guidance on the meaning of ‘independent capacity’ in SP 1/01, the test seems to have been both expanded and narrowed:

- Expanded – by stating in paragraph 46 that non-residents that are ‘qualifying funds’ for the purposes of FA 2022 Sch 2 para 9(1) (the Qualifying Asset Holding Companies regime) will be considered to be independent of their UK investment manager regardless of whether they are a widely held collective fund or being actively marketed with the intention that it become one.
- Narrowed – by providing stricter guidance on the meaning of being ‘actively marketed’ in paragraph 49, and by lowering the threshold for the substantial services test to 50% rather than 70% in paragraph 51.

Non-resident funds that are not ‘qualifying funds’ may be faced with fresh compliance challenges. Of particular concern is the statement in paragraph 49 of SP 1/01 that ‘[o]perating on a business-as-usual basis with an expectation that the position will rectify itself is not sufficient’, as this may put significant pressure on capacity-constrained funds to show active fundraising efforts that demonstrate they are being actively marketed with the intention of becoming widely held. It is also unclear why the threshold for the substantial services test has been lowered to 50%, or indeed how HMRC have settled on this specific percentage; appropriate arm’s length remuneration (which is already tested under the customary rate test in Condition E) should be sufficient to demonstrate economic independence, even if an investment manager derives a significant portion of its revenue from one fund.

As noted, the removal of the ‘if (and only if)’ wording in CTA 2010 s 1146 clarifies that the IME is a statutory safe harbour available in addition to the general AIS exemption, rather than as the exclusive exemption applicable to investment managers. HMRC recognise this in paragraph 55 of SP 1/01; however, they also note that: ‘HMRC considers it likely that a genuinely independent investment manager should meet the conditions of the Investment Manager Exemption’ – HMRC appear to have a presumption against independence for managers that fail the IME.

The road ahead

The proposed amendments (including the amendments to the non-statutory guidance in SP 1/01) are open for consultation until 7 July 2025. Whilst the reform of the domestic PE definition and AIS exemption are likely to worry certain non-resident funds and family offices managed by UK investment managers, the changes to the IME are overall positive, albeit with a number of technical points that need working through prior to implementation to avoid unexpected outcomes. It remains to be seen whether the government will be open to industry feedback on this new limitation through the consultation process. ■

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- ▶ Report: Tax Update Spring 2025 (30.4.25)
- ▶ PE and the investment management exemption (R Kinghall Were & B Salehy, 30.4.25)