The Value to the UK Economy of UK-Domiciled Authorised Investment Funds

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KPMG LLP (UK)

AUDIT ▪ TAX ▪ ADVISORY

Contents

1	Executive summary	4
2	Background and Objectives	6
2.1	The AIF industry is approaching a tipping point	6
2.2	The case for change	6
3	Methodology	8
3.1	Economic Benefit	8
3.2	Value Added	8
3.3	Analysis Undertaken	8
4	Analysis of value added in the Fund management industry	9
4.1	Overview	9
4.2	Production: Investment Management	9
4.3	Sales and marketing: selling Funds to investors	10
4.4	Finance and Administration	11
4.5	Conclusion	13
5	Quantifying the value added	14
5.1	Approach	14
5.2	Results – analysis of TERs by destination	14
5.3	Average TERs by country	15
5.4	Conclusion	16
6	How changes in Gross Value Added affect tax revenue	17
6.1	Tax revenue generated	17
6.2	Approach	17
6.3	Results	19
7	Is the UK tax regime for Funds detrimental to the UK Exchequer?	20
7.1	Comparison between Ireland, Luxembourg and UK	20
7.2	Future projections	21
8	Conclusion – the benefit to the UK of AIFs	24
9	References	25
Appendix I		26
Appendix II		27

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Glossary

ACD	Authorised Corporate Director
ALFI	Association of the Luxembourg Fund Industry
AMC	Annual Management Charge
AUT	Authorised Unit Trust
AIF	Authorised Investment Funds - UK-domiciled AUTs and OEICs
DFIA	Dublin Funds Industry Association
EFAMA	European Fund and Asset Management Association
FUM	Funds Under Management
Funds	UK AIFs and overseas equivalents
HMRC	Her Majesty's Revenue and Customs
IMA	Investment Management Association
Investment Management	The management of designated investments on a discretionary or non−discretionary basis under the terms of a management agreement. This function may be performed by the Fund Manager himself but is usually delegated.
KPMG/IMA Report	Taxation and the Competitiveness of UK Funds, published October 2006.
Fund Manager	The corporate entity that operates and promotes AIFs, this includes the ACD of an OEIC and the Authorised Fund Manager of an AUT.
OEIC	Open-Ended Investment Company
SICAV	Société d'Investissement à Capital Variable
TER	Total Expense Ratio
UCITS	Undertakings for Collective Investment in Transferable Securities – Funds subject to the UCITS Directive (85/611/EEC)
Value added	Income *plus* profits

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1 Executive summary

The KPMG/IMA Report, Taxation and the Competitiveness of UK Funds (October 2006), concluded that unless the UK acted to ensure that it had a competitive tax regime, Fund management groups would increasingly domicile Funds in other jurisdictions (notably, Luxembourg or Ireland). A counter-argument sometimes made is that, even though the Funds may re-locate, the main functions which add value (such as the investment management function) are independent of domicile and will remain in the UK. Both statements are broadly true - what matters is the quantum.

While investment management as well as marketing and advertising activities tend not to be affected by the choice of Fund domicile, our analysis shows that there is still a strong link between the domicile of Funds and the location of *administration activity and other support service*s and that these activities create significant value added.

This paper seeks to quantify the amount of UK value added and corresponding tax revenues that are likely to be lost as a result of Fund Managers choosing to domicile their Funds outside the UK.

We estimate that the £468 billion of Authorised Investment Funds (AIFs) currently domiciled in the UK generate annual fee income of £5.8 billion for Fund Managers and other service providers. Of this amount, £4.9 billion relates to items which are generally invariant to domicile (mainly the core investment management and sales functions) while £929 million (approximately 0.20% of FUM) relates to administration and other costs which *are* generally linked to the domicile of the Fund.

Using standard economic assumptions, we calculate that the £929 million linked to AIFs generates £334 million of UK tax revenue *per annum* based on the size of the current market. If the current yield from Schedule 19 SDRT of £70 million is included, total domicile-related tax receipts are £404 million *per annum*. **Another way of looking at this is that for every £1 billion of Funds domiciled offshore, which could have been domiciled in the UK, nearly £1 million *per annum* has been lost by the UK Exchequer.**

Significant flows of funds can happen over the course of ten to twenty years. The story of Ireland supports this: had reform taken place fifteen years ago, and had Funds now in Ireland been established in the UK, tax revenues from UK AIFs would today have been almost twice as much as they are.

All of this £404m of annual tax revenue is at serious risk as long as the relative position of the AIFs continues to decline. There is clear evidence that this is happening as:

- Increasing imports from Funds domiciled in Luxembourg and Ireland are taking market share from UK funds;
- Progressive and alternative Funds (i.e. the industry's growth areas) are typically domiciled outside the UK because the UK's tax regime is not resilient enough to cope with modern investment techniques; and
- Forthcoming liberalisation of the European regulations governing cross-border mergers and pooling will bring down barriers that prevent Funds from moving to these jurisdictions that have a competitive advantage.

Given these threats, foregoing £70m of SDRT revenue as part of a range of measures could help

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to preserve the £334m of wider revenue identified above. Doing nothing could put at risk, the entire £404m of UK tax revenue.

Furthermore, Funds under management are growing rapidly around the world. The UK will lose significant future tax revenues if it persists with a regime that excludes it from that growing market. If reform is undertaken with the objective of sharing in future growth of the European market, tax revenues could well increase further. To seek to give an indication of the size of the potential revenue at stake our analysis shows three scenarios:

Scenario 1: no reform is undertaken and AIFs decline to zero over fifteen years. In this situation, the net present value over a fifteen-year period of future tax revenues associated with the activities that are linked to Fund domicile is £2.6 billion.

Scenario 2: reform is undertaken (including abolition of Schedule 19 SDRT) and AIFs' FUM remains constant at £468 billion. In this situation, the net present value of future tax revenues associated with the activities that are linked to Fund-domicile is £3.7 billion over a fifteen-year period.

Scenario 3: reform is undertaken (including abolition of Schedule 19 SDRT) and AIFs grow in line with the forecast compound annual growth rate for the European Funds industry of 10.2%. In this situation, the net present value of future tax revenues associated with the activities that are linked to Fund-domicile is £7.7 billion over a fifteen-year period. The difference between Scenario 1 and Scenario 3 is £5.1 billion.

The evidence for reform of the UK tax treatment of AIFs is compelling and that the package must include the abolition of Schedule 19 SDRT. Without reform, the relative market position of AIFs will continue to decline. The only question is at what rate. With action now, the decline could be halted with potential benefits to the Exchequer of over £5 billion.

KPMG and the IMA extend their thanks to the investment management groups that assisted in this research with their valuable experience in managing in excess of 10 per cent of AIFs in the UK and over US $300 billion of Luxembourg funds.

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2 Background and Objectives

2.1 The AIF industry is approaching a tipping point

The KPMG / IMA Report concluded that the UK Funds industry is approaching a tipping point. Luxembourg and Ireland have become the established European Funds centres over the past fifteen years and the UK's relative position has deteriorated steadily over that time. There is every reason to expect the deterioration to continue, for two reasons:

- First, the domicile of a Fund is of decreasing importance to UK investors who have traditionally been sold AIFs rather than SICAVs. The growth of the UCITS brand and the increasing availability of information on offshore funds mean that UK investors are now more likely than in the past to invest via an offshore vehicle. The changes to the offshore fund regime in 2004 contributed significantly to this trend by allowing for the use of separate share classes for UK investors.
- Second, the mainstream and alternative sectors are converging and as AIFs become more complex, the UK tax regime shows increasing signs of strain. Managers were asked to rate the UK, Luxembourg and Ireland tax regimes across a range of vehicle types and asset classes. The UK rating was particularly low in respect of "alternative" asset classes or strategies (for example, property or hedge funds) and in respect of modern Fund structures (for example, exchange traded funds or pension fund pooling schemes). These are the industry's growth areas.

2.2 The case for change

HM Treasury and HMRC have responded positively to the above conclusion and over the past year have furthered dialogue with UK Fund managers with the intention of making the UK tax regime more competitive. However, it is important to the UK Government that any changes to the taxation regime are at least revenue neutral.

The KPMG/IMA Report made the following recommendations to arrest the decline in the relative position of UK AIFs:

- Encourage improved consultation and strengthened trust between the industry, HMRC and other regulatory bodies, and promote understanding of the industry
- Address the property fund conundrum
- Seriously consider abolition of the Schedule 19 SDRT regime
- Allow AIFs to trade without incurring a corporation tax charge and consider full tax exemption

Of the above four measures, the abolition of Schedule 19 SDRT is the one that directly affects tax receipts[1]. In a recent consultation paper[2], HM Treasury states that the current yield from Schedule 19 is £70 million per annum.

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[1] The KPMG / IMA Report estimated that the corporation tax yield from AIFs is £85 million per annum. To the extent that investors are subject to UK tax, this essentially represents a payment on account, since AIFs must distribute all their income annually. Exemption would therefore be broadly tax neutral.

[2] HM Treasury, *Stamp duty reserve tax – Schedule 19: a discussion paper*, November 2007.

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If it can be shown that the erosion of tax revenue as a result of Funds being domiciled outside the UK is greater than £70 million, there is a strong case to take forward a package of reform that includes abolition of Schedule 19 SDRT.

The IMA has therefore asked KPMG LLP to quantify the current benefit in terms of tax revenue and GDP of having £1 billion of Funds domiciled in the UK. By considering historic trends, it then estimates the effect that a package of reform as outlined above might have on tax receipts.

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3 Methodology

3.1 Economic Benefit

The size of the UK's Fund management industry is generally measured by the FUM of AIFs, £468 billion at 30 September 2007 (source: IMA). Although this is an interesting and important statistic, it is not the most relevant for present purposes. The economic benefit that the UK derives from its flourishing Fund management industry is measured by its *value added,* which is equal to the spending on salaries of those employed, and on other services such as premises, research and information technology, plus the profits made on their activities.

3.2 Value Added

Value added is derived from the fees charged for managing and servicing those Funds, typically up to 2 per cent of FUM. These fees buy services, pay salaries, and costs, and create profits. But in which countries will such fees be spent? To what extent does the migration of Funds from the UK to Luxembourg or Ireland impact jobs, services profits and taxation in the UK? To answer this we need to analyse the industry in some detail, in order to understand what the people in the industry actually do, and where (in what country) they might do it. Section 4 provides this analysis. Section 5 then quantifies the value of those services.

3.3 Analysis Undertaken

IMA members, who together manage 10 per cent of AIFs, have provided detailed data to us. All have global investment management businesses and operate Fund ranges in Luxembourg and the UK. For each Manager we studied comparable Fund ranges domiciled in UK and Luxembourg and then:

- Identified the fees and charges deducted from the assets of each Fund range and paid to the Managers and other service providers;
- Carved out those fees and charges, the destination of which is not influenced by the domicile of the Fund;
- Identified the proportion of the remaining fees and charges that are paid to UK-based service providers and therefore add value to the UK economy; and
- Estimated the tax revenue to the UK by applying a standard percentage (36%) to the value of the fees and charges deducted that remain in, or are remitted to the UK.

Using this approach we were able to estimate the UK value add and tax revenue created by each additional £1 billion of Funds that are domiciled in the UK rather than Luxembourg.

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4 Analysis of value added in the Fund management industry

4.1 Overview

In most industries, the activities undertaken can be divided into three functions:

- Production
- Sales and marketing
- Finance and administration

Although from an external perspective it may seem as though most of the value-added resides in production, in most businesses the sales function is equally important or more important. Most businesses also have substantial overhead costs, which mainly centre on the administration and finance function: staff have to be recruited and paid, sales have to be monitored and invoiced, financial and management accounts have to be prepared and audited, taxes have to be calculated and paid, and regulations have to be understood and compliance monitored.

The financial service industries are no different from other industries in this respect. The core activity of the Fund management industry is the investment function: the selection of assets and the management thereof. This investment management function is the essential production element in the industry and it accounts for around one-third of the total costs paid by investors in Funds. The largest cost, as in many other businesses, is the cost of sales and marketing, which typically accounts for around one-half of total costs. The remaining one-sixth of the costs covers the overheads associated with running the business and provides profit.

The mechanisms used to charge fees to Funds and investors, to pay for these three functions and provide profit, vary somewhat depending on the type of Fund, the domicile and the approach used by the Manager. But in general terms there is an AMC, an *ad valorem* charge, made against the assets of the Fund levied by the Manager, and then further specific charges to the Funds by the Manager or other external parties for specific items such as custody, administration or audit. The Manager will need to pay certain parties such as the investment manager and the distributor, out of the amounts received from the AMC (unless, as sometimes happens particularly in non-UK domiciled Funds, these items have been specifically charged to the Fund). The total annual expenses charged to the Fund as a proportion of FUM (whether the AMC or other direct costs) is known as the Total Expense Ratio (TER).

4.2 Production: Investment Management

The core production activity relates to the process of selecting, reviewing and transacting in the underlying assets held in the Fund's portfolio. This activity generally requires highly qualified individuals, access to quality research and market information, portfolio modelling systems and other infrastructure and support services.

It is often said that investment management is a highly international industry, and to an extent that is true. Investors from all over the world buy managed Funds, and their savings are in turn invested in companies from all over the world. In principle, the investment management function could be located anywhere where there is access to a high-quality international communications network. That is why the industry is highly sensitive to the tax treatment it receives. Given that it could, in principle, locate anywhere, it has a strong incentive to locate in the jurisdiction with the most favourable tax system.

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However, there are practical limits to the extent to which an investment management business can relocate. The skills deployed by investment managers are found in clusters in the major financial centres, including London and Edinburgh where there is a long-established tradition and the required infrastructure and support services are well-developed. The total value of investment portfolios, including Funds, managed from the UK is estimated by IFSL (International Financial Services London, one of the independent cross-sectoral organisations representing the UK financial services industry) at over £3.8 trillion[3], making the UK one of the largest markets in the world alongside Japan and the US.

It used to be common that the investment management function was located close to the underlying assets, UK equity managers therefore tended to be UK-based and US equity managers tended to be US-based. This model can still be found, but improved communication and globalisation has made this less prevalent. It is also the case that certain strategies, for example quantitative analysis, rely on computer analysis of historic data, rather than forward looking qualitative research, and can therefore more easily be carried out remotely. Managers of these strategies can be more mobile than traditional managers.

So, even though it might make sense from a tax perspective to relocate Fund vehicles from the UK to say, Luxembourg, it may also make sense to continue to use UK-based investment skills – outsourced as it were from Luxembourg. Indeed IFSL data show that at 31 December 2006 there was £230 billion of assets in Funds where the core investment management activity was conducted in the UK but where the Funds were domiciled outside the UK.

4.3 Sales and marketing: selling Funds to investors

Similar considerations apply, even more strongly, to the marketing function. The money spent on marketing a Fund is not spent in the country where the Funds are managed, or in the country where the business is located. It is spent in the country where the product is being marketed. To persuade Belgians to invest in your Fund you need to spend money in Belgium.

In the specific context of Funds there are typically two main components of sales and marketing costs:

- First, a distribution fee or commission paid by the Manager to a distributor such as an Independent Financial Adviser or a bank. In the case of AIFs this commission is usually paid by the Manager from the AMC it deducts from the Fund. In the case of Funds domiciled in Luxembourg the distribution fee is usually charged directly to the Fund and is separate from the AMC.
- Second, the Manager will also have staff on its payroll undertaking not only marketing and selling activities, including liaising with distributors, but also perhaps promoting the products through advertising and sponsorship activity. A marketing function typically also includes the activity of designing and developing new products. The cost of this activity is ultimately borne by the investors and is recovered by the Manager through the AMC.

The sales activity will generally be conducted in the State in which the *investor* is located, though some of the marketing activity will be conducted where the manager is headquartered. In neither case will the legal domicile of the Fund be relevant.

[3] The total managed by members of the IMA is £3.1 trillion (source: IMA).

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4.4 Finance and Administration

The analysis is more complicated for the administration function, as this category includes a range of services and Managers operate different models.

4.4.1 Transfer agency / investor servicing

Transfer agency is the term used to describe the investor servicing function for Funds. All Funds must have a transfer agent. This function includes:

- Processing of applications for shares or units in the Fund including undertaking money laundering checks, processing investors' payments and sending out contract notes which confirm the transactions to the investor;
- Liaising with distributors such as financial advisers including payment of commissions;
- Processing transactions in shares including sending payments to exiting investors;
- Maintaining the share register for the Fund;
- Sending periodic statements to investors;
- Paying distributions (similar to dividends) from the Fund to the investors; and
- Dealing with enquiries from investors and advisers regarding their holdings.

This function is the responsibility of the Manager. It is increasingly common for the function to be outsourced to a specialist provider. For AIFs, the costs in relation to transfer agency may be borne by the Manager (paid from the proceeds of the AMC levied on the Fund), although a registration charge is also usually made to the relevant Fund that will cover all or part of the costs for transfer agency.

It is usual for this function to be undertaken in the country of domicile of the Fund and, indeed, some regulators (certainly in Ireland and Luxembourg, although not the UK's FSA) *require* the register to be maintained in the country of domicile. So, if Funds move from the UK to Ireland or Luxembourg, the entire Transfer Agency function will move as well.

4.4.2 Fund accounting and pricing

The Fund accounting and pricing function is essentially an accounting, valuation and record-keeping function that includes:

- Processing transactions that the Fund makes in the underlying investments;
- Processing corporate actions, dividends and coupon payments that occur in the underlying investments;
- Reconciling cash and investment holdings to the custodian's records;
- Preparation of share prices based on the underlying Net Asset Value, usually done daily;
- Calculation of distributions by the Fund in accordance with accounting, regulatory and taxation rules;
- Preparation of annual audited managers' reports and accounts and the interim (half yearly) reports and accounts; and
- Completion of tax returns and other reporting.

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As with transfer agency, this function is also the responsibility of the Manager and it is increasingly common for the function be outsourced to a specialist provider, who may also be the custodian. The costs for Fund accounting is typically borne by the Manager for an AIF, although for a Luxembourg or Irish Fund this is typically charged direct to the Fund.

Again, although there are exceptions, it is usual for this function to be undertaken in the country of Fund domicile. Some regulators (again, in Ireland and Luxembourg, but not the UK's FSA) *require* the daily prices to be approved or issued in the country of domicile.

4.4.3 Trustee / depositary

In the UK, a Fund is required to have a depositary in a different group and independent of the Manager. The definition of independent varies from jurisdiction to jurisdiction.

The trustee/depositary performs a primarily caretaking role with respect to the investments, their management and the investor's rights to the property in the scheme. The trustee/depositary has following specific responsibilities:

- Holding legal title to the fund property and ensuring its safe custody;
- Ensuring that the scheme property is invested by the manager in accordance with the specified investment strategy;
- Ensuring that the manager is pricing the units correctly;
- Collecting income tax paid and making tax reclaims;
- Keeping records to demonstrate compliance with the regulations;
- Paying distribution of income to the investors;
- Creating and cancelling units upon instructions from the Manager.

Some of the functions may be delegated by the trustee/depositary to a custodian, but the primary responsibility of oversight cannot be passed on and the trustee/depositary will remain responsible at all times for any acts or omissions of the Manager in performing his duties.

4.4.4 Custody

As above, the custody function is often delegated by the trustee or depositary while retaining the regulatory responsibility for it. Charges for these services are levied directly against the Fund.

The custodian holds the underlying investments and is responsible for their safekeeping. In addition a custodian will generally:

- Hold any un-invested cash element of a Fund;
- Maintain duplicate records of the Fund in respect of its investment holdings;
- Settle transactions for assets purchased and receive settlement for assets sold;
- Receive and pass on voting instructions regarding corporate actions; and
- Reconcile its records with those maintained by the Fund accountant and the investment manager.

A fee for custody will be levied directly against the Fund. A Fund will typically appoint a custodian located in the same domicile as the Fund and fees will be paid to that domicile in the first instance. However, custody is a global activity which uses a network of sub-custodians and

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much of the work will be actually conducted in the country where the underlying assets are based.

4.4.5 Other external services

A number of other services are provided either directly to the Fund, and so paid by the Fund, or to the Manager, and so paid by the Manager. These typically include items such audit fees, legal services, printing and distribution, and regulators' fees.

These services are generally dependent on domicile. The audit will be conducted by auditors in the country of domicile, lawyers advise on Fund laws relating to country of domicile, the Fund is regulated by the regulator in the country of domicile and so on.

4.4.6 Other overheads of the Manager

The Manager will need to pay for the general running costs of the business including:

- Information technology infrastructure and systems;
- Support functions such as human resources, finance, compliance and legal;
- Regulators' fees;
- Product development;
- Senior management and non-executive directors; and
- Premises and facilities.

In addition, an element of the income made will generally be used to reinvest in future growth strategy and another element will be for profits and dividends.

The costs of these overheads will generally be borne from the income received by the Manager through the AMC and will generally be incurred where the Manager is headquartered. Again, Fund domicile is not generally significant.

4.5 Conclusion

The analysis of the supply chain in the Fund Management industry suggests that:

- The Fund's investment management function will be located where there are the best and most competitively priced investment managers - this is therefore invariant to Fund domicile.
- The sales and marketing spend will take place in the countries where the Funds are being sold to investors - this is also invariant to domicile;
- Custody (rather than the trustee / depositary function) takes place where the underlying assets are located – this is invariant to Fund domicile; and
- The trustee/depositary, administration and finance functions tend to follow the Fund, although this is not a hard and fast rule.

The following analysis therefore concentrates on the fourth category. It estimates how much of the administration and finance function is currently linked to the Fund in practice.

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5 Quantifying the value added

5.1 Approach

Data was obtained from four Managers ("the Participants") selected on the basis that they operated substantial Fund ranges domiciled in both the UK and Luxembourg. AIFs managed by the participants account for 10 per cent of total AIFs in terms of FUM. Luxembourg Funds managed by the participants total over US $300 billion. In some cases, the Participants provided data for entire Fund ranges; in other cases, they provided data for a representative sample.

The TER for UK and Luxembourg Fund ranges in the sample were analysed by function and the percentage of the TER that remains in, or is paid to the UK for various costs and services, was identified for both ranges.

As explained in section 4, the majority of the TER comprises the cost of investment management and distribution. All the Participants agreed that the Fund's domicile has no influence on where these costs are spent. No further analysis was undertaken and these costs are described as "invariant".

The analysis therefore focussed on those aspects of the TER that could be influenced by the location of the Fund, either because regulation dictates that local providers must be used, or because it is more convenient to use local providers. These costs are described as "potentially variant" i.e. potentially linked to the Fund. The actual variant amount can be estimated by taking the difference between the proportion of an AIF's potentially variant costs that ends up in the UK and the proportion of a Luxembourg Fund's potentially variant costs that ends up in the UK.

This difference expressed as a percentage of TER can then be used to estimate the value added by the AIFs industry to the UK economy when the AIFs themselves are located in the UK.

It is generally assumed that amounts paid to UK service providers remain in the UK. It is possible that fees paid to a UK-based service provider could be onward-charged outside the UK. The Participants were asked to adjust their analysis where this was known to happen.

5.2 Results – analysis of TERs by destination

The results are set out in the tables below. They are based on averages weighted for each jurisdiction according to each participant's total FUM in each jurisdiction.

Table 1 below shows how the percentage of the fee income (or TER) from UK domiciled funds is spent and further analyses the cost between what is variant to domicile and what is invariant. Table 2 shows the same results from the analysis of a sample of Luxembourg Funds.

The analysis shows that 19.5 per cent of the costs borne by the UK domiciled funds are potentially variant to domicile and that 16 per cent are actually linked to Fund location. For Luxembourg funds, 24.1% of the costs are potentially variant to domicile and that virtually none of this is spent in the UK.

By taking the difference between the two Fund ranges, the results show that 16 per cent (actually 15.9 per cent, being 16.0 less 0.1) of the TER benefits the host economy. Why else would these services be provided from the UK? The fact that the Participants do not use UK suppliers to provide the same services to comparable Luxembourg ranges suggests that money is being spent in the UK because the Funds are domiciled here rather than because the UK has a strong competitive advantage in those service areas.

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Table 1: UK AIFs

	TER (% of FUM) Weighted Av.	Total	Invariant	Potentially variant	
				UK	Rest of world
Operation of Fund[4]	0.092	*6.9%*	*0.0%*	*6.8%*	*0.1%*
Distribution	0.296	*22.4%*	*22.4%*	*0.0%*	*0.0%*
Management	0.765	*57.8%*	*57.8%*	*0.0%*	*0.0%*
Administration	0.034	*2.6%*	*0.0%*	*2.6%*	*0.0%*
Tr. agency / registration	0.083	*6.3%*	*0.0%*	*2.9%*	*3.4%*
Custody	0.005	*0.4%*	*0.4%*	*0.0%*	*0.0%*
Trustee/ depositary	0.012	*0.9%*	*0.0%*	*0.9%*	*0.0%*
Taxe d'abonnement	n/a	*n/a*	*n/a*	*n/a*	*n/a*
Audit & professional	0.005	*0.3%*	*0.0%*	*0.3%*	*0.0%*
Other Fund expenses	0.033	*2.5%*	*0.0%*	*2.5%*	*0.0%*
Total	**1.324**	***100%***	***80.5%***	***16.0%***	***3.5%***

Table 2: Luxembourg SICAVs

	TER (% of FUM) Weighted Av.	Total	Invariant	Potentially variant	
				UK	Rest of world
Operation of Fund[4]	0.152	*8.2%*	*0.0%*	*0.1%*	*8.1%*
Distribution	0.366	*19.7%*	*19.7%*	*0.0%*	*0.0%*
Management	1.046	*56.1%*	*55.2%*	*0.0%*	*0.9%*
Administration	0.010	*0.5%*	*0.0%*	*0.0%*	*0.5%*
Tr. agency / registration	0.043	*2.3%*	*0.0%*	*0.0%*	*2.3%*
Custody	0.019	*1%*	*1.0%*	*0.0%*	*0.0%*
Trustee/ depositary	n/a	*n/a*	*n/a*	*n/a*	*n/a*
Taxe d'abonnement	0.029	*1.5%*	*0.0%*	*0.0%*	*1.5%*
Audit & professional	0.001	*0.1%*	*0.0%*	*0.0%*	*0.1%*
Other Fund expenses	0.196	*10.5%*	*0.0%*	*0.0%*	*10.5%*
Total	**1.863**	***100%***	***75.9%***	***0.1%***	***24.0%***

5.3 Average TERs by country

The data collected above on a sample basis can then be applied to all Funds in Ireland, Luxembourg and the UK. Table 3 shows average TERs as a percentage of FUM as at July 2007 for all Funds domiciled in those three centres. The average TER for AIFs is 1.24 per cent.

[4] Operation, management and distribution are the constituents of the AMC. Not all managers provided a split of the AMC along these lines, so the above is not an accurate reflection of the split between these three functions. In the absence of a split the amounts were treated as invariant.

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Table 3: Weighted average of retail and institutional TERs

	Management	Admin.	Custody	Other	Subsidy[5]	Total
	%	%	%	%	%	%
Ireland	*0.95*	*0.17*	*0.07*	*0.22*	*(0.09)*	*1.32*
Luxembourg	*0.98*	*0.15*	*0.09*	*0.29*	*(0.09)*	*1.42*
UK	*1.12*	*0.08*	*0.05*	*0.06*	*(0.07)*	*1.24*

Source: Lipper Fitzrovia, July 2007[6]

It can be argued that, were the UK to seek to become an international Funds centre with an increased number and variety of overseas investors, or were it to become an established base for alternative Funds, the value added by UK-based administrators and service providers, and therefore tax revenues, would increase.

This is because the average UK TER is lower than Ireland and Luxembourg and possible reasons for this are:

- The international nature of Luxembourg Funds tends to lead to a higher TER. A wide range of markets means that Funds must provide translations and tailor information to satisfy a greater number of regulators.
- TERs are higher for alternative asset classes such as hedge funds, funds of hedge funds and real estate (separate Lipper Fitzrovia data supports this).

The following analysis does not explore this theory further as it is difficult to substantiate it. The current average TER will be used as the basis for calculations.

5.4 Conclusion

This chapter shows that the average TER for UK domiciled funds is 1.24 per cent of FUM and of this amount, 16 per cent is incurred in respect of activities that are dependent on the domicile of the Fund. In turn, this means that every year, 0.20 per cent of FUM is spent on activities that are dependent on the domicile of the Fund.

The next chapter considers what these numbers mean in terms of tax revenue.

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[5] Fees will appear in the subsidy field in two situations: 1) the promoter has committed to a TER cap – if the management, servicing and other expenses exceed this level, the promoter is obliged to reimburse the Fund; 2) the promoter takes an arbitrary decision to waive fees.

[6] Lipper Fitzrovia data separates retail and institutional Funds – the above figures are a weighted average of the two sets of data.

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6 How changes in Gross Value Added affect tax revenue

6.1 Tax revenue generated

In section 5 we showed that 0.20 per cent of FUM of UK domiciled funds is spent every year, in accordance with the domicile of the funds. We have estimated that the amount of tax receipts generated for the UK from that spend is 36 per cent. This section sets out how we have estimated that figure using standard economic data and techniques.

6.2 Approach

The amount of tax generated by additional revenues accruing to the UK Fund management industry will depend on how those revenues are divided between wages and salaries on the one hand and profits on the other. In the absence of such information, we have calculated the tax effect by assuming that the rate of profit of the Fund management industry is the same as the UK average. This means that we can calculate, broadly, the average return to government on the nominal gross value added as the sum of:

- Taxes on production (corporation tax, business rates)
- Taxes on income and wealth (income tax, social security contributions, council tax)
- Taxes on expenditure (VAT, excise duties, customs duties)

The treatment of taxes in the national accounts (and in particular constructing appropriate tax bases for each type of tax) is not straightforward. Gross value added can be broken down into the compensation of employees, the gross operating surplus of corporations and 'other income' (which includes the profits of self employed individuals and the non-corporate sector, and other adjustments).[7] For simplicity we divide national income into:

- Gross operating surpluses (profits) to which we apply the average rate of tax on corporate profits
- Wages, salaries and other income to which we apply the average rate of tax on household income (see below)

We deal with taxes on expenditure by applying an average rate of consumption tax to *total household expenditure*.

The calculation of the average tax rates that we apply to each of these large aggregate tax bases is set out below.

1. *Tax on profits* is the sum of corporation tax plus business rates which amount to 21.5 per cent of corporate profits, as shown in Table 4. We omit Petroleum Revenue Tax since PRT receipts are clearly unaffected by Funds relocating abroad.

[7] GVA at factor cost is transformed into GDP at market prices by adding taxes on production (*less* subsidies) and a statistical discrepancy.

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Table 4: Taxes on production & corporate profits in FY 2006/07

	£ million	**% of corporate profits**	**% of GDP**
Corporation tax	44,300	14.6	3.3
Business rates	21,000	6.9	1.6
Total	**65,300**	**21.5**	**4.9**

Note: Corporation tax is not classified as a tax on production by the ONS, but a tax on corporate-sector income
Source: HMT PBR Table B8, ONS Economic Accounts Table A3

2. *Tax on household income* is the sum of income tax, National Insurance Contributions (NICs) and council tax, which amount to almost 30 per cent of household income (as shown in Table 5). Because of transfers (social security benefits of all kinds) and income from dividends and interest, total household income at market prices is actually larger than total income from wages and salaries at factor cost. At the margin, when jobs go abroad, we apply (to the lost wages and salaries) the average tax rate paid on total household income. Capital gains tax and inheritance tax receipts are not included in the calculation because we make the conservative assumption that when jobs move abroad, these taxes do not move.

Table 5: Taxes on household income in FY 2006/07

	£ million	**% of household income**	**% of GDP**
Income tax & NICs	230,700	27.0	17.4
Council tax	22,200	2.6	1.7
Total	**252,900**	**29.6**	**19.1**

Source: HMT PBR Table B8, ONS Economic Accounts Table A3

3. *Tax on expenditure* consists of VAT plus all the various customs duties set out in Table 6. These taxes amount to 15.5 per cent of total household expenditure. This tax rate is applied to a tax base that is calculated by applying the household consumption ratio to the net income remaining after deducting the taxes in Table 5. So we are assuming, for simplicity, that the households who move abroad behave like average UK households, even though the marginal income that moves abroad is pure wage and salary income.

Table 6: Taxes on expenditure in FY 2006/07

	£ million	**% of household expenditure**	**% of GDP**
VAT	77,400	*7.6*	*5.9*
Fuel duties	23,600	*2.3*	*1.8*
Stamp duties	13,400	*1.3*	*1.0*
Tobacco duties	8,100	*0.8*	*0.6*
Alcohol duties	8,000	*0.8*	*0.6*
Other Customs duties and levies	8,800	*0.9*	*0.7*
Vehicle excise duties	5,100	*0.5*	*0.4*
Other taxes and royalties	13,900	*1.4*	*1.1*
VAT	77,400	*7.6*	*5.9*
Fuel duties	23,600	*2.3*	*1.8*
Total	**158,300**	***15.5***	***12.0***

Note: 'Other taxes and royalties' category includes VAT refunds and National Lottery Distribution Fund
Source: HMT PBR Table B8, ONS Economic Accounts Table A3

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6.3 Results

Table 7 summarises the approach by bringing together the three main tax bases and the average tax rates to be applied.

Table 7: Summary of the tax base and taxes as in FY 2006/07

	£ million	**% of total GVA**
Proposed tax bases		
Gross Value Added at factor cost, of which	1,158,235	
Gross operating surplus	304,258	26
Wages, salaries & other income	853,977	74
Household final expenditure	1,020,593	
		% of respective tax base
Taxes		
Taxes on production	65,300	21
Taxes on household income & wealth	252,900	30
Taxes on expenditure	158,300	16
Total	**476,500**	

Source: HMT PBR Table B8, ONS Economic Accounts Table A3 and A40

Table 8 goes on to show how the disaggregated tax rates shown in Table 7 translate into an overall tax rate on Fund management revenues of 36%. It is assumed that of the additional £1m of revenue, 74 per cent is wages and salaries and 26 per cent is profits. The wages are taxed at 30 per cent and the profits at 21 per cent – the average tax rates shown in Table 7. It is assumed that the additional wages and salaries is divided between consumption and saving in the same ratio as total household disposable income – in other words we multiply post-tax income by 1 minus the savings ratio to calculate the additional consumption resulting from the additional income (i.e. Consumption + Saving = B – tax). This consumption is then assumed to generate additional taxes on expenditure at the average 16 per cent rate.

These calculations deliver an overall tax rate on the additional revenues of 36 per cent. This is slightly lower than the tax to GDP ratio reported in the latest Pre-Budget Report, basically because, as discussed above, there are parts of the tax base that do not move abroad when incomes move abroad.

Table 8: Illustration of tax revenue for every £1 million boost to UK GDP

Tax base			**Tax rate**	**Tax yield**
GDP [A]	1,000,000			
of which				
Wages and salaries & other income [B]	737,309		*30%*	224,739
Consumption		494,865	*16%*	77,823
Saving		17,706		
Profits ([A] - [B])	262,691		*21%*	56,379
Total tax yield on [A]			***36%***	**358,941**

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7 Is the UK tax regime for Funds detrimental to the UK Exchequer?

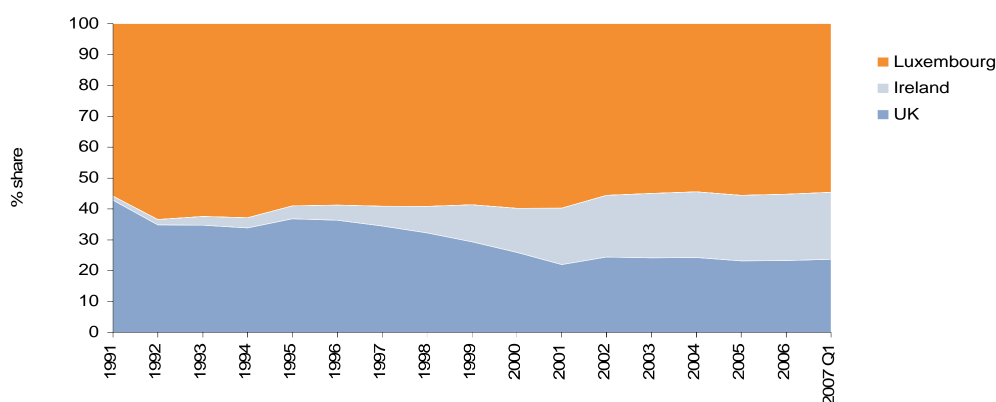
7.1 Comparison between Ireland, Luxembourg and UK

The KPMG/IMA report concluded that taxation has a significant impact on the decision of where to locate a Fund. Also, it was clear from our interviews with Managers that the costs of migrating Fund ranges are prohibitive and a relocation of a Fund range is a rare event. However, the proposed changes to EU regulation as set out in the Asset Management White Paper will make cross-border mergers much easier.

In addition, the UK regime is not attracting new money at the same rate as Ireland and Luxembourg. There is an effective migration of Funds if investors are pointed towards overseas vehicles and there are net redemptions in the corresponding range of AIFs. Figure 1 shows the increase in FUM in Ireland, Luxembourg and the UK from 1991 to the second quarter of 2007. This period has seen a rise in Ireland's FUM from EUR 2.5 to 813 billion and in Luxembourg's from EUR 103 to 2,047 billion, whereas the UK's growth has been less striking, from EUR 79 to 900 billion. (See Appendix I)

The overall growth in Europe of FUM is very rapid, reflecting increases in savings, the proportion going to Funds of this kind and asset prices. Because the rise is so rapid, it is helpful to focus on the relative position of the UK, which is shown in the chart below. Figure 1 shows the extent to which the UK has enjoyed less rapid growth than the combined UK/Ireland/Luxembourg market. Both the UK and Luxembourg have lost to Ireland, but anecdotal evidence suggests that Irish growth has been at the expense of the UK more than of Luxembourg.

Figure 1: Share of total UCITS and Non-UCITS[8] Funds under management in the UK, Ireland & Luxembourg



Source: EFAMA, ALFI, DFIA and IMA

[8] The figure for non-UCITS includes UK investment trusts.

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7.2 Future projections

Although the loss of UK market share appears to have slowed in recent years, there is every prospect that the rate of erosion will accelerate. The EU Commission is behind a drive to facilitate cross border Fund mergers and pooling techniques that are rare at the present time[9]. Over the course of the next three to five years, it should become easier and less costly to relocate Funds to the optimal location. The relative position of the UK is therefore likely to deteriorate further.

Any future projections are speculative. What is clear from the data is that significant flows of Funds can happen over the course of fifteen years. It is reasonable to assume that a proportion of the Funds established in Ireland over the past fifteen years could have been established in the UK and that the UK tax regime for Funds has turned away business from the UK

This assertion is supported by the evidence from the KPMG/IMA report showing the extent to which Fund Managers sell offshore funds rather than AIFs within the UK. Since changes were made to the UK's offshore fund regime in July 2004, offshore funds have accounted for an average of 21 per cent of net sales into the UK over the course of two years (the figure was 1 per cent in the two years prior to the change). These statistics suggest that, as long as the present disadvantageous tax regime persists, the entire £468bn of UK AIFs could be steadily replaced by offshore funds.

The implications of this for tax revenue are profound. At present the government benefits from £70m of SDRT that is generated by the UK AIFs plus, as preceding sections have shown, tax revenue worth 36 per cent of the UK value added by UK domiciled funds. This amounts to £404m as Table 10 below shows.

Table 10: Summary of tax revenues

UK Funds under Management	£468bn
Total expenses accrue at a rate of	1.24% of FUM
Income generated (= UK value added)	£5.8 bn
Of which dependent on domicile	16% of income generated
	0.2% of FUM
	£0.9 bn
Generating tax revenue at a rate of	36 per cent
Delivers tax revenue of	£334 m
Plus SDRT of	70 m
Total tax revenue of	£404m

If UK FUM are gradually replaced by offshore funds, ALL of this revenue is arguably at risk. But if a package of reform is carried out, including abolition of Schedule 19 SDRT, the KPMG/IMA report suggested that the risk would be greatly reduced.

Figure 2 illustrates the point with a stylised calculation. Appendix II shows a table of supporting calculations.

[9] EU Commission, Initial Orientations of Possible Adjustments to UCITS Directive (85/611/EEC), April 2007

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Scenario 1 shows what would happen to the tax revenues generated by the domicile-variant element of UK FUM if SDRT is retained and FUM gradually disappear over a period of 15 years. Tax receipts fall over a 15 year period from £404m to nil. The cumulative net present value of the receipts is £2.6 billion.

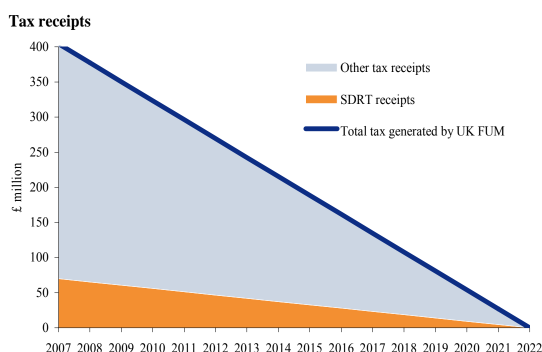
Scenario 2 shows what happens if the taxation of AIFs is reformed along the lines proposed in the KPMG / IMA Report, and the UK FUM tax base remains intact. Tax revenues are a steady £334m per annum. The cumulative net present value of the receipts is £3.7 billion over a 15-year period.

Scenario 3 shows what would happen if taxation of AIFs is reformed as proposed in the KPMG/IMA report, and the UK FUM tax base grows in accordance with projected European compound annual growth rate (CAGR) of 10.2% (source: FERI). Tax revenues would increase to £1.4 billion per annum by 2022. The cumulative net present value of the receipts is £7.7 billion over a 15-year period.

The final graph shows the difference between these three scenarios. A package of reform could produce a revenue loss for three years but a much more substantial revenue gain thereafter. On these assumptions and using a discount rate of 5 per cent, the net present value of tax revenues on the reform scenario (Scenario 2) exceeds the NPV of revenues on the no reform scenario (Scenario 1) by £1.2 billion if AIFs were to disappear over a period of 15 years.

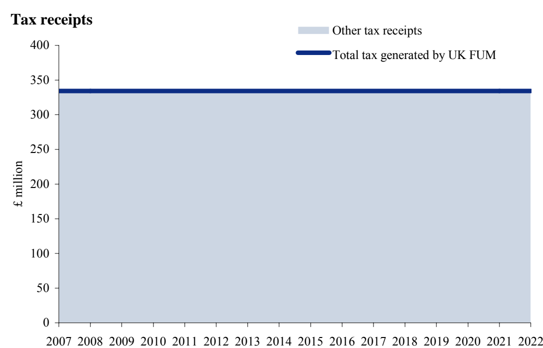
Figure 2: stylised example of SDRT and other tax revenues from UK Funds under management under two scenarios

Scenario 1: No reform and UK domestic Funds eroded over 15 years



Total tax revenues under retention scenario: **£3.2 billion (£2.6 billion NPV)**

Scenario 2: Reform and UK Funds maintained at current level



Total tax revenues under abolition scenario: **£5.3 billion (£3.7 billion NPV)**

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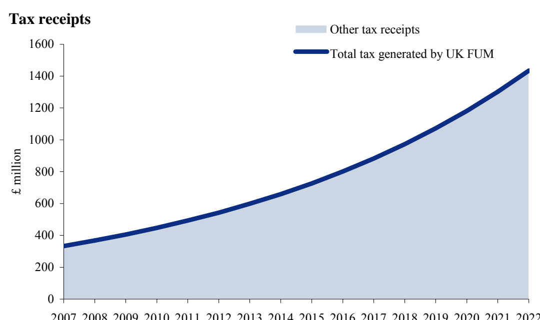
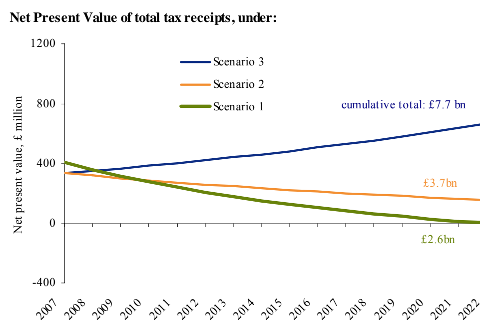
Scenario 3: Reform and UK Funds grow at 10.2% p.a. (based on FERI forecast)



Summary: Net present value of tax receipts under each scenario



Total tax revenues under growth scenario: **£12.2 billion (£7.8 billion NPV)**

Total (cumulative over 15 years) difference in tax revenues, in net present value terms (using 5% discount rate):

- **Between Scenario 1 and Scenario 2: £1.2 billion**
- **Between Scenario 1 and Scenario 3: £5.1 billion**

Scenario 3 paints a more optimistic picture than scenario 2. The story of the last fifteen years helps put the numbers in context: had reform taken place fifteen years ago, and had Funds now in Ireland been established in the UK, annual tax revenues from UK AIFs could today be almost twice as much as they are.

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8 Conclusion – the benefit to the UK of AIFs

Industry data shows that the average UK TER is 1.24 per cent. As the total FUM at September 2007 was £468 billion, the estimated value-added by the entire UK AIF industry is therefore £5.8 billion.[10]

Our analysis has determined that the proportion of the TER that is dependent on the domicile of the Fund is 16 per cent, or 0.20 per cent of FUM. At current levels of FUM, for UK domiciled Funds this equates to £929 million per annum. This in turn generates tax receipts for the UK Treasury of £334m ***in addition to*** the £70m of SDRT revenue estimated by the Treasury.

There is a substantial economic argument to support the abolition of Schedule 19 SDRT as part of wider package of reform for the reasons set out below.

There are three forces coming together that mean UK domiciled funds are at serious risk - these are:

- Increasing imports of Funds domiciled in Luxembourg and Ireland are taking market share from UK Funds in their home market and this is not being offset by UK exports;
- Progressive and alternative Funds (i.e. the industry's growth areas) are typically domiciled outside the UK because the UK's tax regime is not resilient enough to cope with modern investment techniques; and
- Forthcoming liberalisation of the European regulations governing cross-border mergers and pooling will mean that the key barriers preventing Funds from moving away from the UK will be coming down.

The consequence of these three points combined is that tax receipts of £404m from Funds are seriously under threat. Foregoing £70m of SDRT revenue as part of a range of measures would help to preserve £334m of wider revenue; doing nothing could put at risk the entire £404m of UK tax revenue.

This assumes a defensive position i.e. that reform is undertaken to preserve the current position. If reform is undertaken with the objective of sharing in future growth of the European market, tax revenues could well increase further. The story of the last fifteen years supports this theory: had reform taken place then, and had Funds now in Ireland been established in the UK, tax revenues from UK AIFs could today be almost twice as much as they are. Tax revenues would increase for two reasons: first, the value added is linked to the value of FUM; second, were AIFs to be distributed more widely internationally and become appropriate vehicles for more complex products such as property and hedge funds, fees paid to service providers as a percentage of FUM would be likely to increase.

More optimistically, it is possible that tax reforms would allow UK AIFs to compete with their Irish and Luxembourg counterparts and to participate in the benefits of capturing some of the share in the international market.

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[10] *International Financial Markets in the UK* (IFSL, 2007) estimated that the value added by Fund management (a term that covers a wider range of activities than the AIF value chain) was £8.2 billion in 2005. This suggests that administration and other services supplied to UK AIFs accounts for around 14% of the total.

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Appendix I

UCITS and Non-UCITS Funds under management (EUR million)			
	UK	Ireland	Luxembourg
1991	78,947	2,507	103,049
1992	91,843	4,665	167,442
1993	137,409	11,315	247,078
1994	133,126	13,032	247,502
1995	163,150	18,801	261,798
1996	191,055	25,950	308,605
1997	228,246	43,216	391,766
1998	264,580	70,946	486,843
1999	367,147	149,857	734,518
2000	378,573	208,337	874,586
2001	341,904	284,177	928,447
2002	370,235	303,881	844,508
2003	434,601	361,760	953,302
2004	490,969	434,589	1,106,222
2005	644,458	584,505	1,525,213
2006	744,558	729,553	1,844,850
2007 (Q2)	899,698	813,044	2,047,022
CAGR 1996-2006	*15*	*40*	*20*

Source: EFAMA

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Appendix II

	Scenario 1				**Scenario 2**				**Scenario 3**				Effect of scrapping SDRT £ million	
	UK FUM £ billion	SDRT receipts £ million	Other tax receipts £ million	Total tax generated by UK FUM £ million	UK FUM £ billion	SDRT receipts £ million	Other tax receipts £ million	Total tax generated by UK FUM £ million	UK FUM £ billion	SDRT receipts £ million	Other tax receipts £ million	Total tax generated by UK FUM £ million	*Under Scenario 2*	*Under Scenario 3*
2007	468	70	334	404	468	0	334	334	468	0	334	334	-70	-70
2008	437	65	312	377	468	0	334	334	516	0	368	368	-43	-9
2009	406	61	290	350	468	0	334	334	568	0	406	406	-16	56
2010	374	56	267	323	468	0	334	334	626	0	447	447	11	124
2011	343	51	245	296	468	0	334	334	690	0	493	493	38	197
2012	312	47	223	270	468	0	334	334	761	0	543	543	65	274
2013	281	42	201	243	468	0	334	334	838	0	599	599	92	356
2014	250	37	178	216	468	0	334	334	924	0	660	660	119	444
2015	218	33	156	189	468	0	334	334	1018	0	727	727	146	538
2016	187	28	134	162	468	0	334	334	1122	0	801	801	173	639
2017	156	23	111	135	468	0	334	334	1236	0	883	883	200	748
2018	125	19	89	108	468	0	334	334	1362	0	973	973	226	865
2019	94	14	67	81	468	0	334	334	1501	0	1072	1072	253	991
2020	62	9	45	54	468	0	334	334	1654	0	1182	1182	280	1128
2021	31	5	22	27	468	0	334	334	1823	0	1302	1302	307	1275
2022	0	0	0	0	468	0	334	334	2009	0	1435	1435	334	1435
	Total Tax Revenues, in Net Present Value terms:												Total effect, in NPV terms:	
Total NPV over 15 years, assuming 5% discount rate:	2,997	448	2,140	2,589	5,240	0	3,743	3,743	10,797	0	7,712	7712	**1,154**	**5,123**

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