

Taxation of Funds of Alternative Investment Funds

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The long awaited introduction of funds of alternative investment funds (FAIFs), which came into effect on 6 March 2010, provides new opportunities for UK authorised retail funds to be set up providing access to funds which cannot themselves be authorised. FAIFs are authorised collective investment schemes (CISs) that can invest up to 100% of their assets in unregulated CISs, such as hedge funds or unauthorised property funds. They can be marketed and distributed to retail investors with appropriate investor safeguards.

A FAIF may be established either as a non UCITS retail scheme (NURS) or a qualified investor scheme (QIS). Whilst the manager of a FAIF may take advantage of this additional flexibility, they are required to carry out initial and ongoing due diligence. This includes determining that the property of that scheme is held by a third party independent of the scheme's manager.

The FAIF rules also allow 'master/feeder' structures in which the FAIF 'feeds' the majority of its assets into a master scheme, which in turn invests in a wider range of underlying schemes. The master scheme may be based in the UK or abroad. Where a master/feeder structure is used, the manager of the UK authorised FAIF (the feeder) is responsible for ensuring the master scheme operates consistently with the FSA rules specifying the investment powers and borrowing limits for FAIFs.

Tax efficiency

The tax treatment of such vehicles is important, as without the necessary changes to the existing UK Offshore Funds rules, AIF investors will find FAIFs unattractive compared with offshore equivalents. The introduction of a new, elective tax regime for FAIFs, which improves the unfavourable tax position of UK funds investing in offshore non-distributing or non-reporting funds is a helpful step forward, although as explained below there still same way to go and some traps for the unwary.

From a tax perspective, without new rules, AIFs investing in non-distributing or non-reporting offshore funds would be subject to tax on the income gains at a rate of 20% on the realisation of their investments.

No corresponding distribution would be allowed, because gains are accounted for as capital and as such the tax cost is a real cost to investors.

Under the new legislation for Funds Investing In Non-Reporting Offshore Funds (FINROFs), the tax point is shifted from AIFs to their investors making a FINROF exempt from tax on any offshore income gains realised on the disposal of its investments. However, any gains realised by the UK investors on the disposal of their units/shares in the AIF will be subject to tax as income.

The managers of the AIFs must notify HMRC and participants of the funds that the AIF has entered into the FINROF regime. This must be done within a period of three months beginning with the date when the investment condition is met. Failure to comply with either of the requirements could lead to a penalty of up to £3,000.

An authorised fund will automatically be treated as a FINROF if more than 20% of the gross asset value is invested in non-reporting offshore funds (the 'investment condition'). An AIF which does not meet the investment condition may elect to be treated as a FINROF by writing to HM Revenue & Customs (HMRC) within three months of the date on which it is intended to be treated as such.

An AIF which inadvertently fulfills the investment condition may be treated as if it had never met the investment condition provided conditions under regulation 85J below are met. This is likely to result in increased administrative costs for those funds who invest approximately 20% of their gross asset value in non-reporting offshore funds.

- the legal owner of the AIF gives notice in writing to HMRC of the steps that the fund has taken, or proposes to take, to ensure that the fund no longer meets that condition,
- the fund ceases to meet the investment condition within a four month period beginning with the date that the fund first met the condition, and
- a written confirmation from HMRC that this regulation applies.

Although the regulations are helpful, there are still some issues that need to be addressed and, as mentioned, some traps for the unwary.

As they stand, the FINROFs regime will be of benefit primarily to AIFs with tax exempt investors only. Previously tax exempt investors would have suffered a tax cost of 20% at the fund level. Under the new regime tax exempt investors will no longer suffer a tax cost on their investments.

The current legislation potentially acts as a barrier for AIFs which invest in reporting funds as well as non-reporting offshore funds (mixed funds). Under the new regime, UK investors will pay tax on the entire gain arising from disposal of a FAIF as income. This is regardless of the fact that part of the realised gains could derive from reporting offshore funds.

Complications could arise for AIFs who, for example, are awash with excess management expenses and invest more than 20% in non-reporting funds. This may be increasingly the case if, as a result for example of the changes to taxation of foreign profits, manager looks for alternative investments to utilise higher excess management expenses. Under the old rules, an AIF with excess management expenses could offset the expenses against income gains from investment in non-distributing/non-reporting funds (ie there being no tax cost at the fund level) and UK investors would be subject to tax on the disposal of their units/shares in the AIF as capital gains. The FINROFs regime, however, means that although there would still be no effective tax cost at the fund level, UK investors will be subject to tax as income on any gains realised on the disposal of their units/shares in the AIF.

The legislation will allow UK investors to elect in their tax returns, for the year in which the AIF became a FINROF, to be treated as having disposed of and immediately re-acquired the units/shares for their market value at the time when the fund became a FINROF.

Conclusion

The introduction of FAIFs enables a wider range of innovative investment strategies for UK investors through authorised onshore vehicles. It also provides more choice and a better opportunity for risk diversification while maintaining proper consumer protection.

As it stands, the FINROFs regime has relatively narrow application. This has been recognised in the March Budget and it is intended that the Government will continue to work with the industry on the issue of mixed funds and to consider further development of the regulations following the initial introduction of FINROFs regime.

In the interim though AIF, which are not funds of funds should take care to ensure that the 20% limit of investment in non-reporting or non-distributing funds are not breached (unless all the investors are exempt investors, where there would be no impact at the investor level).

The FSA also notes that the proposed Alternative Investment Fund Managers Directive (AIFMD), the text of which is currently being negotiated, may have an impact on the FAIF regime. This is because the scope of the AIFMD may, once finally agreed upon, cover UK's NURS regime and how the third country aspects might affect EU investor choice.

Who should I contact for assistance?

If you would like to discuss any of the matters raised in this release further, please contact Anne Stopford or Dana Ward on the details below.



Anne Stopford
Tax Partner
T +44 (0)207 865 2285
E anne.stopford@gtuk.com



Dana Ward
Tax Partner
T +44 (0)207 728 3316
E dana.ward@gtuk.com