

# Offshore funds regime

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After ongoing consultation between the Government and the industry, the draft Offshore Funds (Tax) Regulations 2009 (the draft regulations) were released on 4 September 2009. These are still subject to Parliamentary approval. HM Revenue and Customs (HMRC) has also published draft guidance on these regulations on 2 October 2009. Please note that the draft currently laid before the House of Commons for approval has been amended from the draft published on the HMRC website in September to correct a number of minor errors including terminology used, cross reference errors and typographical points. Of particular note are the changes of technical substance which have been made to regulations 20, 29, 53 and 63.

The original aim of the regulations was to remove impediments from the UK tax regime for multi-tiered fund structures, by simplifying the operation of the offshore funds tax regime and providing more certainty to UK investors and funds. Although the removal of the 5% test for investment in other offshore funds goes a long way to achieving this aim, it is questionable whether the requirements of the reporting funds regime are simpler than the current distributing fund rules. However, the ability now for accumulation funds to apply for reporting fund status is a welcome development and potentially enables fund promoters to simplify fund structures going forward.

## Reporting and non-reporting funds

The new regime will replace the concept of distributing funds and non-distributing funds under the current regime with that of reporting funds and non-reporting funds and comes into effect on 1 December 2009. For existing funds, transitional provisions mean that the earliest period for which they can apply for reporting fund status is the first accounting period beginning on or after 1 December 2009, but they have the option of delaying entry into the regime for the subsequent period as well.

In a similar way to the current position under the distributing funds regime, a UK investor who disposes of an interest in a reporting fund will be subject to tax on any gains realised as capital gains rather than income. Such investors will also be subject to income tax on the distributions received from the offshore fund and their share of the excess of the offshore fund's reported income over the distributions made (i.e. they will be subject to income tax on their share of the offshore fund's income regardless of whether this is distributed or not).

In contrast, any gain realised by a UK investor on the disposal of an interest in a non-reporting fund will be subject to tax as income and not capital. However a loss arising on disposal of an interest in a non-reporting fund remains a capital loss and cannot be offset against gains arising on that fund or other non-reporting funds.

In view of the current significant differential between rates of income tax and capital gains tax for UK individual investors and the implications for some UK institutional investors whose gains are exempt from taxation, such as authorised funds and investment trust companies, the ability of funds to obtain reporting fund status may be key for funds targeted at UK investors.

## Entry into the reporting fund regime

In order to become a reporting fund, the manager of the fund must apply to HMRC within three months of the first day of the period of account for which it is to be a reporting fund. The application must include documents such as:

- A statement of the first period of account for which it is proposed that the fund should be a reporting fund
- An undertaking that no period of account will exceed 18 months
- A statement of whether the fund intends to prepare its accounts in accordance with international accounting standards (IAS). Where the fund does not intend to use IAS the application must state which generally accepted accounting practice it intends to use
- Undertakings to comply with the requirements to provide information to investors and HMRC
- A copy of the prospectus.

## Duties of reporting funds

A reporting fund is required to prepare its accounts in accordance with IAS or in accordance with the generally accepted accounting practice specified in its application to become a reporting fund. The regulations then provide for detailed adjustments to the 'total comprehensive income for the period' (or the equivalent if non-IAS accounts are being used as a starting point). For example adjustments must be made in relation to:

- Items which would be accounted for as capital if the accounts were drawn up in accordance with the Investment Management Association's Statement of Recommended Practice (SORP) for UK authorised investment funds
- Expenses relating to the disposal of investments or the setting up, merger and dissolution of the fund

- Interest income to the extent that the accounts are not prepared using the effective yield method for interest income
- Income from underlying reporting and non-reporting funds
- Equalisation adjustments in respect of redemptions during the year.

It is worth noting that investors in funds which do not operate equalisation arrangements may be taxed on a higher amount of income, as such funds will not be able to deduct equalisation on redemptions from the total reportable income. Similarly because reported income per unit of a fund for reporting purposes is calculated by dividing the reported income by the number of units in issue at the end of the reporting period, investors who remain at the end of the period may also be taxed on a higher amount of income where there are large redemptions.

The regulations include a specific provision that a profit or loss from a trade may not be treated as a capital item for the purposes of the regulations. However, to the extent that the fund meets the 'equivalence condition', transactions which fall within a specified list of transactions, which are in line with the white list applying for authorised funds, will not be considered to be trading.

This is clearly a very significant step forward and provides certainty for certain funds, but only to those constituted as UCITS funds or those recognised by the Financial Services Authority (FSA) under sections 264, 270 or 272 of Financial Services and Markets Act 2000 (FSMA). They will also need to comply with the 'genuine diversity of ownership' (GDO) requirements. This however, provides no greater certainty for the majority of hedge funds and careful analysis of the activities of individual funds will be needed to assess whether it is beneficial to apply for reporting fund status.

Although the introduction of equalisation provisions is a positive development since the previous draft regulations, it is disappointing to note that the de minimis exemption is not being retained under the reporting fund regime. Therefore, funds will still need to provide details of reportable income even if the amounts are very small.

The legislation allows a ten per cent margin for error when calculating the reportable income before a breach is made. If a fund has no, or negative, income it will be required to make nil returns.

Reporting funds will be required to make a report available to each investor who is resident in the UK (or which is a reporting fund) within six months of the end of the reporting period. The report must state the amount actually distributed to investors, the excess of the amount of the reportable income over the amount actually distributed, the dates of distributions and a statement as to whether the fund remains a reporting fund. The report can be made available to investors by post, email, website or newspaper. It is worth noting that if the report is provided within six months of the reporting date, the distribution is treated as being made on the date the report is issued and therefore it may be beneficial

to report as late as possible within the rules in order to defer the period of taxation for investors.

Reporting funds will also be required to provide various other information to HMRC, including audited accounts, a computation of reportable income, a copy of the report made available to investors, the reported income of the fund and a declaration that the fund has complied with its obligations. This information must also be provided within six months of the end of the period of account.

### **Leaving the reporting fund regime**

A reporting fund may give notice to HMRC to leave the reporting fund regime on the last day of a period of account. Alternatively, a fund may be required by HMRC to leave the regime if it is in serious breach of its obligations. It must leave the regime if it has made four minor breaches (a breach for which there is a reasonable excuse or which is inadvertent and is remedied as soon as possible) within a period of ten years beginning with the first day of the period of account in which the first minor breach occurs and the legislation does not offer any discretion to HMRC on this point. If a single event results in more than one minor breach within a single period of account it will be treated as only one minor breach in that period.

Although a fund can generally choose to be within or outside the reporting fund regime for each accounting period, if a fund is required to leave the reporting fund regime by HMRC it will be unable to apply to rejoin the regime at a later date.

### **Transitional provisions for existing distributing funds**

Funds currently certified as distributing funds whose accounting periods begin before 1 December 2009 can apply to HMRC to be treated as distributing funds for the period straddling 1 December 2009 (the 'overlap' period) and also the subsequent period. However, the earliest such funds can apply for reporting fund status is for the first accounting period that begins after the date of introduction of the new regime on 1 December 2009. Funds will therefore need to decide whether they wish to come into the regime at the earliest opportunity (and potentially consider shortening their accounting period to do so) or to defer into the regime until a later date. For example for a fund with a 31 October year end, it could elect to defer entry into the regime until the year ended 31 October 2012 if it wished. Much will depend on the fund's distribution policy, investors' view of potentially being taxed on amounts not distributed, the benefit of the existing de minimis exemption and the five per cent investment restriction.

If a fund falls within the scope of the offshore funds regime owing to the amended definition of an offshore fund but did not fall within the scope before December 2009, it may make an application to HMRC, by 31 May 2010, to become a reporting fund for the period of account current on 1 December 2009.

Investors may make an election where a distributing fund becomes a non-reporting fund, or a non-distributing fund becomes a reporting fund, so that they are treated as making a disposal on conversion. This ensures that any inherent gain accumulated in respect of their interest whilst the fund is either a distributing fund or a reporting fund is not prejudiced by the fund being, at a certain point in time, a non-distributing fund or a non-reporting fund. This also applies where a fund converts from a non-reporting fund to a reporting fund and vice versa.

Where a fund is converting its status as outlined above, the effect of the election is that the investor will be treated as having disposed of their interest in the non-reporting fund and acquiring a new interest in the reporting fund, at the end of the fund's final period of account as a non-reporting fund and acquiring an interest in the reporting fund at the beginning of that fund's first period of account. Thereafter any future gain arising on disposals from the time the fund becomes a reporting fund will be taxed as chargeable gains. If an election is not made and a UK investor disposes of an interest in a reporting fund which was previously a non-reporting fund or previously not a distributing fund, they will be subject to tax on the full gain as income.

### **Transparent funds**

There are also provisions dealing with transparent funds, where UK investors are treated as the beneficial owners of the underlying income and are directly taxable on the income in the fund (such as many offshore unit trusts). Transparent funds are excluded from the requirements of the reporting fund regime provided they hold no more than five per cent of their assets in other non-reporting funds and provided they make sufficient information available to their investors to enable them to complete their self assessment obligations. This is likely to cause some operational difficulties for transparent funds investing in underlying funds

### **Conclusion**

The draft regulations provide greater certainty for investors and funds with regards to the new offshore funds regime which will take effect from 1 December 2009, although the publication of the final version of these draft regulations at a relatively late stage gives funds, fund providers and administrators little time to decide what course of action to take and to get the required systems and processes in place.

The new regime is also likely to result in increased administrative costs for these funds who apply to become reporting funds owing to the increased requirements to provide information to both investors and the HMRC. As reporting funds will not need to physically distribute income, this may result in investors being taxed on amounts which they do not receive.

Existing distributing funds will welcome the transitional provisions to allow them to continue, upon application to HMRC, to apply the current offshore funds regime for the current and successive accounting period. However, funds with accounting periods starting before 1 December 2009 will only be able to apply for reporting fund status for the first accounting period commencing after 1 December 2009.

### **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.



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