

# Offshore funds regime

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Following the introduction of The Offshore Funds (Tax) Regulations 2009 (the original regulations), which came into effect on 1 December 2009, further draft amending regulations (the draft regulations) have now been released for consultation by HM Revenue and Customs (HMRC). These draft regulations pick up on issues, which were not fully addressed in the original regulations, as well as addressing issues that have arisen in practice since the original regulations were released.

The draft regulations have been divided into three main categories: equalisation arrangements, transparent funds and miscellaneous amendments.

## Equalisation arrangements

The original regulations stated that where a reporting fund operated equalisation arrangements, then equalisation adjustments in respect of redemptions during the year should be made for the purposes of calculating the reportable income. However, it was widely recognised that in practice the method suggested did not actually work.

The regulations did not address the situation where a reporting fund does not operate equalisation arrangements as the reported income per unit of a fund for reporting purposes was calculated by dividing the reported income by the number of units in issue at the end of the reporting period. As a result, investors who remained at the end of the period may have been taxed on a higher amount of income where there were large redemptions (the last man standing issue).

The draft regulations have addressed both these issues, but have now, unexpectedly, gone so far as to say that equalisation calculations are mandatory and must be carried out whether equalisation arrangements are operated by the fund or not. For offshore funds that are already reporting funds at the date these draft regulations come into force transitional provisions have been included to address the introduction of this requirement.

The proposals require that a reporting fund must now declare in its application:

- whether or not it operates equalisation arrangements
- if it does, whether or not it intends to report equalisation to investors (full equalisation arrangements), or
- if it does not, whether it will make adjustments on the basis of reported income or accounting income.

While we understand that the rationale for not making these adjustments optional is to eliminate the last man standing issue, by making them mandatory, as currently drafted, this will place an additional burden on administrators and increase costs associated with reporting to investors as in practice many funds have not operated equalisation arrangements to date. This is a key issue arising from the draft regulations and one where the industry is continuing discussions with HMRC with a view to the mandatory requirement being relaxed.

## Offshore funds that operate equalisation arrangements

As noted, the draft regulations allow for a fund that operates equalisation arrangements to choose whether it will apply 'equalisation' or 'full equalisation'. While both forms of equalisation will require adjustments to be made, the difference will lie in the information that needs to be communicated to investors. For both forms, the adjustments will result in reportable income for a reporting period being increased by amounts paid for income on issue of units and reduced by amounts of income paid out on cancellation of units during the period, with the result being that reportable income will reflect the changes in the units held by investors over a reporting period.

Where a fund elects to apply full equalisation, there is then an additional requirement that the report to an investor who has purchased units in the period must also include the amount of equalisation per unit that they acquired. In addition, the fund must then decide on whether to calculate the equalisation on an average basis at the fund level for each investor or whether to perform a separate equalisation calculation in respect of each new investor. Whichever method is chosen must be applied for all reports to investors.

From an investor's perspective, when reported income is in excess of distributions made, investors will be able to use the amount of reported equalisation to reduce the amount of excess reported income for the period.

Where a fund operates equalisation the fund is not required to report the equalisation element to investors, which results in new investors being taxed on the same amount of income per unit as existing investors. This is not ideal as it has the effect of converting capital to income for new investors who will be taxed on income that arose in the fund before they purchased units. As such, we would therefore expect most funds that operate equalisation arrangements to operate full equalisation.

### Offshore funds that do not operate equalisation arrangements

In a similar way to the position for funds that operate equalisation arrangements, the draft regulations have introduced the need to make adjustments to the calculation of reported income for funds that do not operate equalisation arrangements.

A fund will need to decide whether it will perform these calculations on the basis of its reported income or its accounting income, and include a statement to this effect in its application, along with a statement of its intended computation period length. This computation period starts at the beginning of a reporting period and immediately after the end of a previous computation period, and ends at the end of a reporting period and on any date on which income is allocated to investors for distribution or accumulation. Where a reporting period consists of more than one computation period those periods must be of equal length.

For a fund choosing to make adjustments to its income on the basis of reported income, the method involves calculating the reported income per unit for each of the computation periods, and then summing these together to give the total reported income of the fund for the reporting period.

The alternative method is for a fund to choose to make adjustments to its income on the basis of accounting income. In this instance the fund should take the sum of the accounting income per unit for all the computation periods and multiply it by the ratio of total reported income for the reporting period over the sum of the accounting income for all the computations in the reporting period.

In addition, there are a number of extra requirements that also need to be satisfied when adopting this method. As part of the application the fund will need to include statements from the manager specifying how the accounting income will be determined, that it is reasonable to expect that the difference between the amount of reported income per unit using this method and that using the alternative method

based on reporting income will be 10% or less, and that should it become clear that the difference will be greater than 10%, an undertaking by the manager to make income adjustments in that reporting period and future reporting periods on the basis of reported income. The fund manager must then also give notice to HMRC of the change in the method of income adjustment in the annual report provided to HMRC.

As can be seen, whichever method is chosen potentially creates a significant amount of additional work, notwithstanding the last man standing issue.

### Transitional provisions

For offshore funds that are already reporting funds at the date that the draft regulations come into force, the draft legislation contains transitional provisions that will apply the new equalisation rules to reporting periods ending after the draft regulations come into force.

The manager of an existing reporting fund must give notice in writing to HMRC within one year of the date of the new regulations coming into force as to how they will approach equalisation. Within this notice they may also elect that this amendment should not apply in relation to reporting periods ended before the date these draft regulations come into force. If no such election is made, then the fund will automatically be treated as not operating equalisation arrangements and intending to make income adjustments on the basis of reported income from the time that the fund first became a reporting fund.

Even if such an election is made, for reporting periods current at the time the regulations come into force this will potentially cause additional administration which would not have been apparent at the beginning of the reporting period.

### Transparent Funds

In the original regulations, specific regulations were introduced in respect of the disposal of an interest in a non-reporting transparent fund, ensuring that no offshore income gain arose on the disposal of an interest in such a fund (provided certain conditions were met). However, no such regulations were introduced in respect of the disposal of an interest in a reporting transparent fund.

This has now been addressed in the draft regulations, with a similar condition being introduced as for that in respect of an interest in a non-reporting transparent fund, being that the fund will need to provide a report to investors that contains 'sufficient information' to enable them to meet their tax obligations. However, there is still no statutory guidance as to what is meant by 'sufficient information' although we understand that this is an area in which HMRC intends to expand its guidance.

An additional issue that has been resolved for transparent funds is that of the issue of investments in other offshore funds by a transparent fund. The draft regulations bring this in line with the original regulations, which only dealt with non-transparent reporting funds that had investments in other offshore funds.

### **Miscellaneous amendments**

#### **Unlisted trading company exception**

If, throughout the period of ownership of an interest in an offshore fund, and at the time of disposal, more than 90% of the value of the assets of an offshore fund consist of holdings in qualifying companies (trading companies, the shares of which are not listed on a recognised stock exchange or admitted trading on a regulated market), then no offshore income gain will arise on disposal.

This draft regulation has been introduced to protect some private equity structures that could now be caught by the offshore funds rules. The ‘throughout the period of ownership’ requirement does raise some concerns with regard to the start and end of life scenarios for such structures, but HMRC is aware of this and is considering it further.

#### **Timing of applications and withdrawals**

The time limit in which an application for an offshore fund to enter the reporting fund regime has been extended by the draft regulations. Application can now be made before the later of the end of the first period of account for which reporting fund status will apply and the expiry of a period of three months from when interests are made available to UK investors.

The application may now be withdrawn before the end of the first reporting period if HMRC is happy that the fund has not breached any conditions.

#### **Index tracking funds**

Where an index tracking fund has a holding in a non-reporting fund the index tracking fund does not need to bring in the income of that non-reporting fund in its calculation of reportable income or treat the fair market value adjustment as if it were income.

The reason for this regulation is to reduce the compliance burden for such funds as it is likely to be immaterial whether the fund held has reporting fund status or not.

#### **Equivalence condition**

The equivalence conditions have been updated such that a wider range of funds can now be considered to be equivalent to UK authorised investment funds.

Going forward, if a fund is constituted in another European Economic Area (EEA) state, is authorised to market to retail or professional institutions, and is required to limit its borrowings and exposure under derivative contracts and forward transactions to 100% of net asset value, then the equivalence condition is met and the fund can access the trading and investment ‘white list’, ensuring certainty that its transactions would constitute being investments.

While this is certainly a welcome amendment it does now put Cayman and other non-EEA based funds at a disadvantage compared to EEA funds.

#### **General diversity of ownership**

Two changes have been made to the regulation concerning the genuine diversity of ownership (GDO) condition. The first of these will mean that GDO can now be applied at sub-fund level (and not just share class level) and is helpful, for example, in the case of management share classes.

The second amendment has been introduced ahead of the introduction of UCITS IV. Investors in a feeder fund (either UK authorised investment fund or offshore equivalent) can now be considered when considering whether a master fund meets the GDO conditions. However, there is one restriction in that the feeder fund and the master fund must have the same manager.

#### **Other**

HMRC has to date accepted retrospective applications for UK Distributor Status (UKDS) where the conditions were met in the period for which the retrospective application related to.

The updated regulations now state that once a fund becomes a reporting fund the fund can no longer go back and make retrospective UKDS applications.

#### **Conclusion**

The fact that HMRC has listened to the industry’s concerns and has tried to address the issues raised is most welcome, and it is clear that it remains committed to working with the industry to make the regime as workable as possible.

However, it is clear that by making equalisation calculations compulsory the draft regulations as they currently stand have introduced added complexities and will involve more work being carried out by funds to ensure that the regulations are being fully adhered to. That said, the industry is continuing in discussions with HMRC and are hopeful that in the final regulations the equalisation calculations may not be mandatory.

These draft regulations are certainly not straightforward and are likely to result in increased administrative costs for those funds that apply to become reporting funds, owing to the increased calculations and requirements to provide information to both investors and HMRC. However the changes probably also largely reflect the increased complexity of the funds marketplace and the variety of products on offer requiring ever more scenarios having to be considered in what was intended to be simplified offshore funds legislation.

### **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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