

# Reporting funds regime

---

November 2010

After ongoing consultation between the Government and the industry, The Offshore Funds (Tax) Regulations 2009 (the Regulations) came into effect on 1 December 2009.

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 new reporting fund regime are simpler than the previous distributing fund rules. However, the ability now for accumulation funds to apply for reporting fund status is a welcome development. The introduction of the reporting fund regime also potentially enables fund promoters to simplify fund structures going forward.

A new tax definition of an offshore fund also came into effect on 1 December 2009, resulting in more funds coming into the regime for the first time and therefore having to consider the impact of the regulations.

## Reporting and non-reporting funds

The reporting fund regime replaces the concept of distributing funds and non-distributing funds under the distributing funds regime with that of reporting funds and non-reporting funds. 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 that period and for the subsequent period as well.

In a similar way to the 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 (ie 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 significant differential between rates of income tax (up to 50% from 6 April 2010) and capital gains tax (now up to 28%) 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 HM Revenue & Customs (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 international accounting standards (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 recognised income and expense 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 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 that do not operate equalisation arrangements may be taxed on a higher amount of income, as such funds will not have any equalisation on redemptions to deduct 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. This is an area of concern for many funds, and one which HMRC is aware of, so it is expected that there will be developments in this area.

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 is a 'diversely owned fund', 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. A diversely owned fund is a reporting fund that meets the equivalence condition and the genuine diversity of ownership condition. The Regulations allow a diversely owned fund (a UCITS fund or are which is recognised by the Financial Services Authority under sections 264, 270 or 272 of Financial Services and Markets Act 2000 and complies with the genuine diversity of ownership requirements) to be treated as carrying out investment activities. The investing versus trading distinction is not always clear and careful analysis is needed on a case-by-case basis for those funds which are not 'diversely owned'. Therefore, for example, a Cayman hedge fund, which is considering applying for reporting fund status due to the relaxation of the distribution rules, will need to consider this carefully before deciding to proceed.

It is disappointing that the de minimis exemption has not been 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 10% 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 point 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. 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, the deadline to make an application to HMRC was 30 June 2010, to become a reporting fund for the period of account current on 1 December 2009. After this date, the reporting fund status applications must be made to HMRC by the time limits set out in the Regulations.

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. The election needs to be made in the tax return for the period which includes the deemed disposal date.

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. Limited partnerships, which are transparent for income and capital gains tax purposes, are outside of the offshore funds definition as investors are subject to tax on income and gains as they arise. Although a fund vehicle established as a partnership is not within the definition, the question arises as to whether an underlying holding vehicle could constitute an offshore fund under the new definition. Other types of arrangements that are transparent for income purposes but not transparent for capital gains purposes fall within the definition of an offshore fund (transparent funds). An investor in a transparent fund will be taxed on a gain as a capital gain not income provided the fund holds no more than five per cent of its assets in other non-reporting funds

and provided it makes sufficient information available to its 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.

### **Changes to improve the transitional arrangements**

Subsequent to the release of the Regulations, certain changes to transitional provisions were made in order to facilitate the commercial operation of funds during the transitional period. Where a new offshore sub-fund is launched, after 1 December 2009, but under the same umbrella arrangements as an existing distributing fund and with the same accounting dates then, to the extent that the existing fund obtains distributing fund status under the transitional provisions, the amended regulations will allow the transitional rules to apply to that sub-fund as they do to the existing fund within the same umbrella.

As above, it will be possible for a fund which falls within the scope of the offshore funds regime after 1 December 2009 but did not fall within the scope before December 2009 to make an application to HMRC to become a reporting fund. To the extent that the fund applies for reporting fund status for a period straddling 1 December 2009, the transitional provisions protect the right to capital gains treatment on certain interests held before the regulations came into force on 1 December 2009, and exempt the 'excess' of reported income over actual distributions for the period before 1 December 2009 from tax in the hands of the investor.

Clarification has also been provided on the time period to apply for reporting fund status. This depends on whether the fund/sub-fund is an existing fund/sub-fund before 1 December 2009. For an existing umbrella fund launching a new sub-fund after 1 December 2009, the time period to apply for reporting fund status starts from the launch date of the sub-fund ie once shares are issued, the three month clock starts. The legislation considers the class of interest as a whole to have been launched with the issue of the first interest (shares/units etc) to investors. This starting point is not restricted to issues to UK investor but to all 'participants'. This contrasts with the position for an existing sub-fund ie one that already exists on 1 December 2009 where the three month clock starts when UK investors come into that fund for the first time after 1 December 2009.

## Late applications for distributing fund status and late distributions

In view of the significant differential between rates of income tax and capital gains tax for UK individual investors, the ability of funds to obtain retrospective distributing fund status is potentially important in mitigating the tax liabilities of UK individual investors

HMRC has set out its views regarding late applications for distributing fund status under Schedule 27 Income and Corporation Tax Act 1988. Broadly, provided all other conditions for approval have been met for an account period, the lateness of an application alone will not be a bar to the acceptance of the application.

In addition, it has clarified the position where in order to satisfy the distribution requirement a late distribution would be needed. The Board of HMRC will now allow additional time for the payment of late distributions in the following circumstances:

- i) where the shortfall is trivial, or
- ii) where the fund can show that the investor profile has remained constant for the period of application and subsequently (ie no redemption for that period), or
- iii) where the fund had a reasonable excuse for not making the distribution within the appropriate time and it then made the distribution as soon as it was able.

Depending on the investor profile and to the extent that the activities of a fund are not trading in nature (careful analysis of the activities of individual funds may be required), it may be beneficial for funds to apply for retrospective distributing fund status, and indeed a number of funds have already done so.

## Conclusion

The regulations provide greater certainty for investors and funds with regards to the new offshore funds regime which took effect from 1 December 2009, and the removal of the 5% holdings test and the requirement for physical distributions is a positive step forward.

However, the reporting fund regime is also likely to result in increased administrative costs for those funds who apply to become reporting funds owing to the increased requirements to provide information to both investors and 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. Many existing distributing funds have welcomed the transitional provisions to allow them to continue, upon application to HMRC, to

apply for distributing fund status for the current and successive accounting period. However, other funds, particularly those which have in the past had to operate reinvestment mechanisms, have welcomed the ability to enter into the regime at an earlier stage. In that regard the new regime allows funds to review the existing share classes and consolidate if appropriate.

## 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 0207 865 2285  
E [anne.stopford@gtuk.com](mailto:anne.stopford@gtuk.com)



**Dana Ward**  
Tax Partner  
T 0207 728 3316  
E [dana.ward@gtuk.com](mailto:dana.ward@gtuk.com)