Hedge fund update

UK tax developments provide an opportunity for increased distribution of offshore alternative funds into the UK marketplace

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Favourable amendments to the UK tax legislation provide an opportunity for the increased distribution of offshore alternative funds into the UK and potentially result in a more beneficial tax position for UK resident investors in relation to their investment in such funds (potentially including the rebate and reward shares of fund managers). The key points to note are:

- A reduction in the capital gains tax rate for UK resident individuals to a flat rate of 18% which was introduced from 1 April 2008;
- An overhaul of the UK offshore funds regime which will be introduced from 1 December 2009: in particular, this represents a move from a distributing to a reporting regime;

As a result, managers and promoters of non-UK alternative funds should review their fund ranges and their distribution strategy into the UK; particularly where UK resident principals in the investment manager entity have co-investment arrangements in place.

Furthermore, these developments may also increase opportunities for certain offshore alternative funds to make tax efficient distributions to UK investors, particularly UK resident individuals who may, in certain circumstances, benefit from a "tax credit" to offset against their taxable dividend income received from the fund.

The move from a distributing to a reporting fund regime

Current position

The UK offshore funds regime is an anti-avoidance tax measure which can result in capital gains on redemptions being taxed as income in the hands of a UK resident investor in certain circumstances. For example, in the case of offshore accumulation funds which "roll up" income on an annual basis - although this facilitates tax deferral for investors until redemption, upon redemption higher rates of UK tax may potentially be payable.

Currently, UK investors in alternative fund vehicles which fall within the scope of the regime will only obtain capital gains tax treatment on disposal of their shares in an offshore fund where that fund is certified as a "distributing fund" on an annual basis (referred to as obtaining UK distributor status (UKDS)). The key criterion for obtaining UKDS under the current rules is, broadly, that at least 85% of the fund's "income" returns must be physically distributed to investors on an annual basis. Income is defined as the higher of the accounting income of a fund under local generally accepted accounting principles (GAAP), or the income of a fund calculated in accordance with UK tax principles (UK Equivalent Profits).

Why do the majority of alternative funds not currently seek UKDS?

If an offshore fund has a mix of both income and capital returns, it would require detailed UK tax analysis to determine whether its returns were capital or income in nature (i.e. whether or not the fund was trading

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for UK tax purposes). Many alternative funds have historically simply assumed that they are trading without undertaking any detailed analysis (especially as the use of shorting, derivatives and leverage may add complexity to such an analysis).

Where a fund's investment strategy would be regarded as "trading" for UK tax purposes, this in practice prevents the fund from obtaining UKDS, as it would be necessary for the fund to physically distribute the majority of its **income returns** (including all trading returns) realised in each accounting period. This would significantly reduce assets under management unless complex dividend reinvestment arrangements were in place.

Funds of funds

Funds of alternative funds have not been able to seek UKDS under the current rules due to the requirement that a distributing fund cannot, broadly, invest more than 5% of its net assets (on a cumulative basis) in other offshore fund vehicles (unless those funds also have, or could obtain, UKDS); this is referred to as the "investment restriction". As the majority of the underlying alternative funds in such structures tend to be accumulating funds they would not be able to obtain UKDS and hence the top fund itself could not obtain UKDS.

Why will this position change?

(a) Introduction of a flat tax rate on capital gains

Currently the highest rate of tax borne on income received by a UK resident individual is 40%, rising to 50% from April 2010. In comparison, capital gains realised by the same UK resident individual would suffer tax at a rate of 18%. As a result, UK resident individual investors (including executives of the fund manager who have co-invested in the fund) will have a preference for receiving capital gains on the ultimate realisation of their investment in an offshore alternative fund.

(b) The trading versus investment distinction – additional clarity added

A number of statements from HM Revenue & Customs ("HMRC"), have provided a degree of clarification as to whether a fund's returns will be regarded as trading (and hence taxed as income) or investment (and hence taxed as capital) for UK tax purposes. In particular, in the revised Statement of Practice 1/01 dated 20 July 2007, HMRC clarified that the use of shorting and derivative techniques should not, in themselves, constitute trading.

Whilst the issue of what constitutes trading versus investment activity is ongoing, it is clear that many alternative funds who use derivatives and shorting may, potentially be regarded as non-trading funds (i.e. they derive investment / capital returns rather than trading income).

(c)The increased ability to reflect returns on fund investments as capital

Where an offshore fund uses derivative instruments, the current rules in relation to the calculation UK Equivalent Profits provide that it may calculate income returns for distribution in accordance with its audited accounts, provided such accounting is broadly compatible with the UK Statement of Recommended Practice (SORP) applicable to UK authorised funds.

Broadly, under the UK SORP, where a fund uses derivatives to hedge or protect capital investments, any returns should be capital in nature. Conversely, where derivatives are used to protect or enhance income returns, any returns derived from those derivatives would be income in nature (and would thus need to be distributed to investors on an annual basis; similar to dividends or interest returns).

Therefore, to the extent that the use of derivative instruments can generate returns which may properly be accounted for as capital under the UK SORP, this would suggest that proportionately less income may

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fall to be taken into account for UK tax purposes under the offshore funds regime. However this is a complex area and it is recommended that specialist advice is sought before implementation of such structures in order to understand the appropriate treatment.

(e) Reporting fund status – an overhaul of the current distributing fund regime

(i) Definition of an offshore fund

As well as modernising the regime to move from a "distributing" to a "reporting" regime (see below), the UK Government has made potentially significant changes to the definition of what constitutes an "offshore fund". In particular, the new definition moves to a "characteristics based" approach (rather than the current, regulatory based definition). Inter alia, this means that a number of closed ended and/or more illiquid structures may now fall within the new definition, where such funds could hitherto have been outside the scope of the offshore funds rules. Fund promoters should take steps to review the impact of these changes on existing and new structures.

(ii) Distributing to reporting regime

The amended requirement to report income (rather than distribute) annually means that a fund can substantially improve the tax treatment of returns in the hands of its investors without the need to physically distribute cash. Therefore, the fund may retain and reinvest all its assets, continue to operate investor lock-in clauses and avoid having to operate costly reinvestment arrangements.

We note that to the extent that a portion of the fund's returns are income (e.g. dividends and interest income), then UK resident investors may suffer tax on a deemed distribution without receiving a corresponding cash distribution to settle their tax liability. Where returns can properly be characterised as capital, such mismatches would not occur.

The investment restriction will also be abolished under the proposed new regime, which is of particular benefit to fund of alternative funds. Going forward, to the extent that the underlying target funds are themselves reporting funds, fund of funds should be able to obtain reporting fund status.

What should alternative fund managers and investors be doing now?

Promoters of offshore alternative funds which are currently within the rules but who do not seek UKDS (i.e. hedge funds) should consider reviewing their products (and reward structures) now to determine whether their funds can achieve reporting fund status in future, and liaising with their marketing colleagues to consider how to manage or promote any change in status for UK resident investors.

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