The final piece of the puzzle? The UK tax reporting regime for offshore funds takes shape

With the first major deadline approaching for annual compliance under the new reporting fund regime, HM Revenue & Customs (HMRC) has issued much anticipated amendment regulations.

The new Offshore Funds (Tax) (Amendment) Regulations 2011, which came into effect on 27 May 2011, address a number of outstanding areas of concern following the publication of the original regulations in November 2009 and subsequent amendment regulations in December 2009. The majority of the changes are as expected following the recent consultation process and HMRC has introduced some further helpful provisions.

While the timing of these amendments means that there will be a number of immediate considerations for funds with compliance obligations for December 2010 year ends, the industry now has further clarity on how HMRC will expect the regime to operate.

Below is a summary of the main areas of the finalised amendment regulations and the issues offshore fund managers will need to address in 2011 to meet their compliance obligations under the reporting regime.

The calculation of reportable income (TRI)

Equalisation

There are now five options available, which result in varying levels of parity for investors joining and leaving the fund during any given accounting period. These range from:

- The option to make no adjustment – while the 'last man standing' risk will still exist, this option is useful for funds which don't expect to have reportable income, don't experience significant fluctuations in ownership or transitional funds for where appropriate information hasn't been monitored during 2010.

- Where the accounting system doesn't track income equalisation but the fund wants to adjust reportable income to minimise the 'last man standing' risk, two options exist to smooth reportable income on an averaging basis, with differing input data required. These are either adjustments calculated on the basis of 'reportable income' or adjustments on the basis of 'accounting income'.

In our view, the first option is more preferable as it allows more precise income smoothing where there are differences between the presentation of net income under local accounting standards and the UK tax measure of income.

- Where the accounting systems are designed to track income equalisation, the fund has the option to adjust reportable income up or down by the balance on the equalisation accounts. This gives accurate smoothing based on the accounting measure of net income.
- For funds which do track equalisation within the accounting system, if appropriate information on how income has accrued in the fund over the accounting period is provided to investors as part of the annual reporting process, joining investors can gain an advantageous tax treatment on their first receipt of income/reported income from the fund.

Fund managers need to make an informed decision on their preferred option based on the specific characteristics of their fund and the system capabilities of their administrators. There are still some practical issues to address on the information accounting systems can currently produce in certain jurisdictions and more clarity is expected from HMRC on certain inputs into the averaging calculations.

For offshore funds which have already accessed the reporting regime from 27 May 2011, two key choices need to be made.

- The manager has until 27 May 2012 to decide on the equalisation method which will be used to calculate TRI in the future. It's important to note that once the method is chosen, it can't be changed for three years.
- For the immediate annual reporting deadlines in 2011 (i.e. accounting periods ended before 27 May 2011), fund managers can choose to elect out of the new equalisation provisions (and apply the old provisions contained in the main regulations). This doesn't affect their choices going forward.

For offshore funds (at share class level) which begin to submit upfront applications post 27 May 2011 (and strictly for those which have applied but not yet secured a launch date), no such extended timelines exist. So the first upfront application made after this date will need to include comment on which equalisation method will be adopted. As all share classes within an umbrella will presumably employ the same method, this means that the decision for certain umbrella funds with newly launched share classes may be brought forward.

More clarity on other aspects of calculating TRI

- Trading activities – Where a fund managers' activities are deemed to be 'trading' (and so form part of reportable income), this produces a highly inefficient result for UK investors. The white list of investment transactions provides certainty on what constitutes non-trading transactions; but only certain funds can access this list. While corporate UCITS (Undertakings for Collective Investment in Transferable Securities) are generally given access, HMRC has now extended access to corporate funds constituted as European Economic Area (EEA) non-UCITS vehicles, where they can demonstrate that they are obliged to meet certain conditions in their use of borrowing and derivatives. Transparent funds still can't access the list (regardless of their European Union (EU) or UCITS status), with investors taxed on their share of the underlying trading profit and most non-EEA vehicles will also still struggle to get access. It's unclear why the same strategy operated in two different vehicles (one in the EU/EEA and one outside) should lead to a different conclusion for TRI purposes. Where access to the white list is denied, fund managers will need to make sure they have considered whether their activities are properly 'investment activities' under UK case law principles.

- Investing in other offshore funds – HMRC has clarified two areas. Firstly, where income from underlying reporting/notional reporting offshore funds is consolidated into the accounts of the top reporting fund, it has clarified that it expects the calculation of TRI to follow the same principles. This may achieve income and expense matching for certain master feeder structures, but also means that the taxation of reportable income from tier two is brought forward for UK investors. Secondly, the index tracking fund exemption simplifies the TRI calculation for funds which meet the relevant conditions. However, this exemption is only expected to have significance for a small number of fund managers and further guidance is needed on the specifics of the conditions before it can be relied on.

Application of the regime to specific vehicles

Transparent funds

While many transparent funds (such as fonds commun de placement (FCPs), common contractual funds (CCFs) and certain unit trusts) have entered the reporting regime, there is still uncertainty around how the UK taxation principle of income transparency will fit with the reporting regime. It is now clear that:

- All transparent offshore funds must provide 'sufficient information' to UK investors to help them to complete their tax returns (regardless of whether they've sought reporting status). 'Sufficient information' remains undefined. With this in mind, managers of transparent funds will need to be satisfied that they're providing appropriate information. This includes:
    - The need to report income as measured for both corporate and individual UK taxpayers.
    - Having a regular reporting process in place -dependent on the UK investor types targeted and the frequency of subscriptions and redemptions from the fund (e.g. quarterly, semi-annual, annual or in some cases more frequently).
- Where a transparent fund has become a reporting fund, HMRC has now made clear that most of the regulations which deal with the calculation and reporting of TRI do not apply (as income has already been reported to investors on a transparent basis). The fund must calculate additional reportable income where it invests in other offshore funds (following the principles of the main regulations). The fund must also keep to the annual compliance deadlines within the main regulations to provide information to investors and HMRC. Importantly such deadlines for this process are annual in contrast to the potential requirements of the transparent reporting process outlined above.

In most cases, transparent funds continue to have a choice for formally applying for reporting status, as it will not change the tax position of the UK investor so long as 'sufficient information' is provided. There are two qualifications to this:

- In general, our clients are finding that reporting status helps conversations with potential investors and distributors.
- Fund managers must be aware that the choice disappears where the transparent fund invests more than 5% of its assets in other non-reporting funds. So it's very important to monitor this requirement on an ongoing basis where the transparent fund has chosen not to seek reporting status.

Unlisted trading companies exemption

Since the introduction of a widened definition of an offshore fund in December 2009, the industry has had significant concerns about the application of the reporting fund regime to private equity funds. Through extensive consultation, HMRC has now issued an exemption it believes should cover the types of arrangement it originally intended to exclude. This broadly covers those where the ultimate investment assets meet the definition of ‘qualifying companies’ under the UK substantial shareholding relief rules. While this is certainly a significant step in the right direction, we believe there are still a number of points around the terminology used in the exemption which need to be clarified in guidance.

Investor taxation

To simplify matters for UK investors (and the calculation of TRI for an offshore fund investing in other reporting funds), HMRC has clarified that regardless of the date the report is issued to participants, the tax point for the reportable income will always be six months following the accounting period end. This replaces a previous complex rule allowing the tax point to vary depending on the date the report was issued. A new anti-avoidance provision also makes sure that UK investors can’t avoid the allocation of reportable income by divesting their interest immediately before the accounting period end and reinvesting days later. While this was not part of the consultation, it’s not unexpected in the context of the wider aims of the reporting regime.

Increased flexibility on entry, exit and deadlines

- Entry – HMRC has addressed the compliance burden associated with the three month rule for entry to the reporting regime. Entry is now permitted up to the later of the end of the first accounting period the fund wishes to be a reporting fund or three months from the date interests are first made available to UK investors.
- Exit – HMRC has extended the time limits for withdrawing from the regime (as opposed to leaving) to make sure that, where possible, fund managers which have sought reporting status but never achieved UK investors are not required to meet annual compliance obligations where there is no additional tax at stake for HMRC.
- Annual compliance deadlines – due to the simplification of the reportable income tax point for investors, there is now no deterrent from meeting annual compliance obligations within ten months of the accounting period end. While we expect that most offshore fund managers will try to finalise their reporting within six months where possible, this additional flexibility will be useful where there may have been delays in the production of accounts or significant decisions need to be taken, for example, on the equalisation method - particularly in year one.

These particular provisions achieve far more simplicity and flexibility for the managers of offshore funds. We understand from HMRC that any offshore fund remaining within the new time limits from 27 May 2011 can begin to apply the amendment regulations from that date onwards.

While there are some areas that need further guidance, the reporting regime is now taking shape in a form which is more pragmatic and flexible than the old distributor status rules.

Contacts

If you have any questions about the new regime, then please contact your usual PwC contact or one of the specialists below.

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