

## Investment Management Draft regulations for the new offshore fund regime issued for consultation

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HM Treasury (“HMT”) recently published partial draft regulations for the new offshore funds reporting regime, which together with the ‘*Offshore Funds: Next Steps*’ paper published by HMT in March 2008 provide further detail on the operation of the regime. The draft regulations confirm that the new regime will come into force in Spring 2009 and that the new definition of an offshore fund will not be introduced until Finance Bill 2009.

In summary, the key features of the regime are the requirement to report income rather than distribute it, the introduction of an upfront certification procedure, the ability to use Generally Accepted Accounting Practices (“GAAPs”) other than International Accounting Standards (“IAS”) and UK GAAP as a starting point for calculating reportable income and new reporting requirements to both investors and HM Revenue & Customs (HMRC). Comments on the partial draft regulations are invited by 11<sup>th</sup> July 2008, and we would encourage interested parties to respond.

Three important new measures contained in the draft regulations are:

- the introduction of an investor election procedure which will allow investors to either preserve capital gains tax treatment on accrued gains where a reporting fund becomes a non-reporting fund or to obtain favourable capital gains tax treatment on future gains where a non-reporting fund becomes a reporting fund;
- the requirement for fund managers to report the names and addresses of each participant in the fund, together with the reported income for each participant which significantly increases the amount of information fund managers will need to provide; and
- the introduction of significant information powers such that HMRC can request any information that it reasonably requires to determine whether a fund has met its obligations under the regime.

It is perhaps worth reflecting that the key aims of HMT in introducing the new offshore fund regime are to reduce administrative complexity, provide greater certainty to fund promoters and investors and to accommodate developments that have occurred in the industry, whilst maintaining the overall tax anti-avoidance objective of the rules. Whilst there are a number of welcome developments, in particular the inclusion of accumulation funds in the regime and the abolition of the 5% investment test, it is difficult to see how these proposals do anything to reduce the administrative complexity of the regime for managers. Indeed, HMRC appears to have done precisely the opposite, with new reporting requirements covering both the funds and their investors. Fund managers will need to consider the proposed regulations very carefully and evaluate their potential wide-ranging impact on their funds and the associated administrative requirements. The Appendix provides further details of the practical implications of the new rules.

## Details of the proposed new regime

### Upfront certification

The draft regulations include provision for advanced certification of funds as reporting funds. The upfront certification is intended to provide investors with certainty that a particular fund has reporting fund status before the fund is marketed to UK investors.

For existing funds, the manager should request advanced certification at least 28 days before the start of the first accounting period of the fund (for new funds the period is 42 days).

The information required to be submitted with an application for advanced certification as a reporting fund is:

- a statement of which accounting standards the fund intends to use;
- the first period of account for which the fund wishes to be certified;
- a statement that no accounting period of the fund will exceed 18 months;
- a statement specifying the figures in the accounts which are equivalent to "total recognised income and expense" under IAS;
- for funds with more than one class of interest a statement that there will be no discrimination between participants with different classes of interest;
- an undertaking to meet the requirements of the offshore fund regulations for reports to participants and information provision to HMRC; and

- a copy of the prospectus (or proposed prospectus for new funds).

HMRC undertakes to respond to an application for advance certification within 28 days of receipt.

### Calculation of reportable income

The regulations permit the use of GAAPs other than UK GAAP and IAS in calculating reportable income, although where a different GAAP is used it is expected that it will be the fund's local GAAP.

In order for a different GAAP to be acceptable to HMRC for use in the income calculation, it must be demonstrated in the upfront approval process that the amount used as the starting point to calculate reportable income is equivalent to "total recognised income or expense for the period" under IAS.

The regulations also state that if there is a change in GAAP used by a fund then notice must be given to HMRC of the change in advance.

Once the equivalent figure under local GAAP to "total recognised income and expense for the period" under IAS is reached, the figure should be adjusted for the following items to arrive at the reportable income figure:

- capital items per the IMA SORP (deduct gains and add back losses);
- disallow expenses relating to acquisition/disposal of investments, and fund set-up costs (i.e. other capital items); and
- adjustments are required for subsidiary holdings,

investments in bond funds and investments into other reporting funds and non-reporting funds.

This will mean that significant accounting and tax reviews may need to be undertaken to ensure that items are treated correctly in arriving at the reportable income figure.

If there is a change in accounting policy within a GAAP permitted by HMT, a prior period adjustment should be recognised for tax purposes in calculating the reportable income.

If new instruments are used by a particular fund, then these will need to be reviewed to ascertain the appropriate accounting treatment in order to calculate reportable income.

### Reporting requirements

The initial consultation on the new offshore fund regime proposed that 100% of fund income was reported to investors. As a result of industry representations the draft regulations now provide that effectively only 90% of the reportable income of a fund has to be reported to HMRC and investors.

If a fund reports less than 90% of reportable income, but more than 85%, this is deemed to be a minor breach and no action will be taken by HMRC if this is rectified. If less than 85% is reported, this will also be a minor breach provided a supplementary report is made to investors before the end of the reporting period in which the error is established. If this does not occur the fund will lose its reporting status.

Reporting funds are required to report the following information to investors within six months of the year end:

- reportable income deemed to be distributed (and the amount per unit);
- amount actually distributed (and the amount per unit);
- distribution date; and
- a statement of whether the fund remains a reporting fund.

There are also requirements for funds to report the following information to HMRC annually:

- audited financial statements;
- calculation of reportable income for the period;
- calculation of the reportable income for the period for each UK participant, together with names and addresses of those participants; and
- a declaration that the fund has complied with the offshore fund regime requirements throughout the period.

### Breaches of reporting fund conditions

If a fund has a minor breach of the regulations (i.e. one which is minor and inadvertent and remedied without delay or one for which there is a reasonable excuse), that fund will continue to be certified as a reporting fund.

If there are more than three minor breaches by the same fund within 10 years then the fund will no longer be certified as reporting.

For significant breaches of the reporting fund rules (i.e. breaches which are not minor), HMRC will inform the fund that it is no longer certified as a reporting fund.

### Investor position

The tax position for UK investors in offshore funds will be as follows:

- UK investors in a reporting fund will be allocated a deemed dividend distribution from the fund (the amount reported to investors by the fund) which will be subject to income tax.

- Dividends will not attract the 10% tax credit for foreign dividends introduced in Budget 2008, as there have been subsequent amendments to the 2008 Finance Bill which deny the tax credit to dividends from offshore funds.

### Change in status of offshore funds

If a reporting fund wishes to voluntarily withdraw from the reporting fund regime, it may do so by notifying HMRC in writing. If a fund voluntarily leaves the regime (for example, because there are no UK investors) then it can re-enter the regime at a later date provided it has completed its obligations under the regime for all previous periods that it was in the regime.

If a fund leaves the reporting fund regime because it is asked to do so by HMRC (i.e. due to breaches of the conditions) it will not be able to apply to re-enter the reporting fund regime at a later date.

### Contacts

If you would like to discuss any aspect of HM Treasury's offshore funds proposals, please get in touch with your usual PricewaterhouseCoopers contact, or alternatively contact any of the people listed below:

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## Appendix

Key measures	Issues
<ul style="list-style-type: none"> <li>Transitional rules from existing regime.</li> </ul>	<ul style="list-style-type: none"> <li>Transitional rules have not yet been drafted – these are expected with the next set of draft regulations. Comments are requested in the consultation on what transitional arrangements should be put in place.</li> </ul>
<ul style="list-style-type: none"> <li>Advanced certification as a reporting fund.</li> </ul>	<ul style="list-style-type: none"> <li>Whilst advanced certification may provide a degree of certainty for fund promoters and investors, in order to maintain reporting fund status fund managers will still be required to meet the on-going requirements of the regime and make an annual submission to both HMRC and investors.</li> <li>Breaches of the rules can be rectified without adverse consequences if minor or inadvertent, providing increased certainty to investors that a fund will remain a reporting fund. However, significant breaches of the rules or repeated minor breaches will result in the loss of reporting fund status with immediate effect such that the fund will be a non-reporting fund.</li> <li>Therefore the rules do not achieve absolute certainty for investors.</li> </ul>
<ul style="list-style-type: none"> <li>Annual reporting requirements to HMRC.</li> </ul>	<ul style="list-style-type: none"> <li>Reporting funds will be required to make an annual submission to HMRC, including financial statements and the calculation of reportable income.</li> <li>In addition they will be required to submit the names and addresses of each participant in the fund, together with the reported income for each participant. This anti-avoidance measure significantly increases the information funds need to provide and is likely to increase administration costs and the complexity of the compliance process. It is also not comparable with the position for UK authorised funds, which are not required to provide this information to HMRC. What will the industry reaction to these requirements be?</li> <li>There is no detail about how the reporting of investor details to HMRC will work in practice. For example, if interests in a fund are held by a nominee account, will a fund be required to identify the beneficial owners behind the nominee account?</li> <li>HMRC will have significant powers to request information under the draft regulations - HMRC can request “any information...that they may reasonably require for the purposes of determining whether the fund has met its obligations.”</li> </ul>
<ul style="list-style-type: none"> <li>Annual reporting requirements to investors.</li> </ul>	<ul style="list-style-type: none"> <li>Information to be provided annually to investors includes the reportable income, any amount physically distributed, the distribution date and a statement as to whether the fund remains a reporting fund.</li> <li>It is intended that this information will not have to be provided to each investor by way of a paper voucher.</li> </ul>
<ul style="list-style-type: none"> <li>Requirement to report 90% of income.</li> </ul>	<ul style="list-style-type: none"> <li>The requirement to report income rather than distribute widens the application of the regime.</li> <li>It is likely that the removal of the physical distribution requirement will result in more funds (both traditional funds and hedge funds) applying for reporting fund status and being sold into the UK.</li> </ul>

Key measures	Issues
<ul style="list-style-type: none"> <li>• Calculation of reportable income – use of alternative GAAPs and accounting concepts.</li> </ul>	<ul style="list-style-type: none"> <li>• Reporting funds will potentially be able to use GAAPs other than UK GAAP and IAS as the starting point for calculating reportable income.</li> <li>• HMRC expects that the local GAAP of the fund’s location should be used.</li> <li>• Reporting funds will need to confirm that the income figure produced by the local GAAP is equivalent to “total recognised income and expense for the period” under IAS. Where local GAAPs are “flexible” (i.e. Luxembourg GAAP) work will be required to ensure that the correct income figure is reported.</li> <li>• Adjustments to “total recognised income and expenses for the period” for capital items will be required to reach the reportable income figure. This will require a review of the local GAAP and a comparison with the UK SORP to determine the necessary adjustments. Any items which would be capital gains or losses under the Investment Management Association Statement of Recommended Practice for Authorised Funds (IMA SORP) need to be identified and removed from the reportable income figure. This means that if profits or losses from the sale of assets are classified as capital by the SORP, they will not be required to be included in reportable income.</li> </ul>
<ul style="list-style-type: none"> <li>• Calculation of reportable income – HMRC to publish a list of acceptable GAAPs.</li> </ul>	<ul style="list-style-type: none"> <li>• In theory this measure should reduce the administrative burden of the regime however as noted above, accounting reviews will be required to confirm that the correct split of profit between income and capital gains is used in the calculation.</li> </ul>
<ul style="list-style-type: none"> <li>• Calculation of reportable income – removal of <i>de minimis</i> test.</li> </ul>	<ul style="list-style-type: none"> <li>• The removal of the <i>de minimis</i> test will mean that income needs to be reported to investors irrespective of the amount of income.</li> <li>• The removal of the <i>de minimis</i> test will therefore increase the administrative burden for funds and investors.</li> </ul>
<ul style="list-style-type: none"> <li>• Calculation of reportable income – equalisation rules.</li> </ul>	<ul style="list-style-type: none"> <li>• Draft regulations on equalisation rules are not yet available. These will be published with the next set of draft regulations.</li> </ul>
<ul style="list-style-type: none"> <li>• Removal of 5% investment restriction.</li> </ul>	<ul style="list-style-type: none"> <li>• The removal of the 5% investment restriction will allow the offshore funds regime to keep pace with changes in the investment management industry, particularly in the development of fund of funds.</li> <li>• A review of all the investments made by reporting funds will be required to assess whether investments are firstly investments in offshore funds, and secondly whether investments in other offshore funds are in reporting funds or non-reporting funds.</li> <li>• If a reporting fund invests in a non-reporting fund it will need to consider whether it has sufficient information about the non-reporting fund to treat it as a notional reporting fund for the purposes of calculating reportable income or whether it will have to calculate the reportable income from the non-reporting fund on a fair value basis. This is therefore more onerous than the current regime.</li> </ul>

<b>Key measures</b>	<b>Issues</b>
<ul style="list-style-type: none"> <li>Investor tax position – deemed distributions.</li> </ul>	<ul style="list-style-type: none"> <li>Investors will be allocated a deemed annual distribution equal to their portion of a fund's reportable income.</li> <li>Investors will be subject to income tax on this deemed distribution irrespective of whether they receive a cash distribution to fund the income tax liability.</li> <li>It is possible that some funds may make a cash distribution in excess of the 90% reportable income requirement. At present there are no regulations dealing with this situation although these are expected with the next set of regulations.</li> </ul>
<ul style="list-style-type: none"> <li>Investor tax position – change in fund status.</li> </ul>	<ul style="list-style-type: none"> <li>To assist investors where a fund changes its status, HMRC has introduced an investor election procedure whereby each investor can make an election to be treated as having made a deemed disposal and reacquisition of the fund.</li> <li>When a non-reporting fund becomes a reporting fund investors can pay tax on the deemed offshore income gain at the time of the election but preserve favourable capital gains tax treatment for future gains.</li> <li>Conversely, where a fund loses reporting fund status investors can pay capital gains tax on accrued gains rather than have all gains be treated as offshore income gains upon eventual disposal.</li> <li>It will be important for fund promoters to advise investors of a change in reporting fund status as soon as possible, in order that investors can make the election for a deemed disposal if required.</li> <li>Investors are required to make the elections in their tax return and will be required to pay tax on the deemed disposal in the income tax year in which they make the election.</li> <li>We note that there is no provision for investors themselves to make the application for a fund to obtain reporting status, as there is in the current distributing regime. This may be a disadvantage for investors where there are only a small number of investors and therefore the fund does not apply itself to join the regime.</li> </ul>