Tax Briefing

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Investment Management

Consultation on a new regime for UK investors in offshore fund vehicles – will the industry benefit?

HM Treasury has recently published a discussion paper on the introduction of a new offshore fund reporting regime to replace the current distributor status regime. With the discussion paper comes the commitment from the Government to bring the tax regime applicable to UK investors in offshore funds more in line with the tax treatment for investment in a UK fund. There is also a clear recognition that the current regime is no longer workable given the development of the EU regulatory environment, and the wider asset management industry, in recent years.

In general, feedback from the industry so far has been positive provided various detailed and practical issues are addressed.

This briefing is the first in a series that will explore particular features of the Treasury's proposals, prior to the closure of the consultation period on 9 January 2008.

Background

Both the current and the proposed regimes set out various criteria in relation to the operation of an offshore investment vehicle, which, if met, will ensure that any UK investors will preserve capital gains tax treatment upon disposal of their holding; a factor that will become increasingly important for individual investors, given the announcement in the Pre-Budget Report to move capital gains tax to a flat rate of 18% from 6 April 2008. If the stipulated criteria are not met, gains realised upon disposal of a holding will be taxed as income in the hands of a UK investor.

Currently, meeting the criteria to become a distributing fund means that an offshore fund is required to physically distribute at least 85% of its annual income to UK investors, thereby ensuring such amounts are brought into the UK tax net on an annual basis. The fund is also, broadly, not permitted to invest more than 5% of its net assets in other offshore funds (the investment restriction).

Under the proposed rules, meeting the new criteria to become a reporting fund will require the offshore fund vehicle to gain approval from HM Revenue & Customs (HMRC) upfront, and then report 100% of its income returns to UK investors and HMRC on an annual basis. Such reported income will become taxable on those investors regardless of whether the income is distributed in cash. The investment restriction will be removed.

Does the proposed regime provide a more flexible, less burdensome alternative, thereby assisting funds to distribute into the UK market place?

The requirement to physically distribute cash disappears and is replaced with the requirement to report income returns to investors and HMRC

Currently, in many funds, UK investors are segregated into separate share classes given the physical requirement to distribute cash. Cash can be re-invested in some circumstances, provided suitable re-investment mechanisms are in place. Going forward, complex and burdensome re-investment mechanisms would no longer be required and in addition true accumulation share classes and sub-funds would now be able to obtain reporting fund status. Both these positive moves should mean cost savings for fund managers and possible opportunities to rationalise their fund ranges. In addition, it could enable the UK investor to access more funds within the market, and achieves parity of tax treatment with investment in UK funds.

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Where income is reported to the investor, but not distributed, the taxation of the income without the receipt of a cash dividend may be seen as disadvantageous, dependent on the tax profile of the UK investor. However, this has been the position for investment in UK authorised funds for many years, and the prevalence of current dividend re-investment mechanisms in the market suggests that this is not a material issue. Importantly, for deemed distributions which have been taxed but are never distributed, care will need to be taken to apply appropriate relief within the capital gains calculation of the UK investor to ensure that they are not subject to double taxation, perhaps through maintenance of a detailed attribution account. In cases where deemed income returns are sizeable (see investment restriction comments below) this could be a significant issue.

Investors attain certainty upfront as to the UK tax status of the fund

Currently, certification as a distributing fund is granted retrospectively, typically somewhere between nine months and one year after the relevant period end of the fund. In addition, no detailed guidance is currently provided on how any minor breaches will be dealt with. This makes it difficult for investors to know what to enter on their tax return in the year when they dispose of a holding. Going forward, funds must apply for and obtain approval before becoming a reporting fund, and then must report income returns on an annual basis to both UK investors and to HMRC, (this is a similar concept to the German tax reporting regime introduced in 2004).

While it is helpful to have a degree of clarity upfront, it is difficult to see how this will significantly change the position as it currently stands; in some aspects the position at best will remain uncertain. Why?

1. Although funds will attain reporting fund status upfront, and further guidance will be provided on minor breaches whereby reporting fund status will not be revoked, HMRC still has the power to revoke this status at any point in time. Further, should revocation occur this would appear to taint the fund for the rest of its life, whereas under the current regime only UK investors holding an interest during the period for which the fund fails to attain distributor status will be affected.

2. The question arises as to what the remedy will be should HMRC deem the calculation and reporting of income to UK investors to be incorrect? Will it require another reporting process to be undertaken? Does this not leave the UK investor in the same position as present, yet could create a double reporting burden for fund managers if errors occur?

3. An entirely new requirement has been added to the upfront approval; the need to confirm that the main purpose, or one of the main purposes, of the offshore fund structure is not the deferral or avoidance of UK tax. It is not currently clear how a fund would demonstrate this, or in what circumstance HMRC would take exception to a particular structure. We suggest that HMRC should make clear what circumstances such a requirement may capture, which are not already covered by existing UK anti-avoidance legislation.

Additionally, it would be helpful if HMRC could confirm that the upfront application process in itself will not be burdensome and will not cause delays in funds going to market in the UK.

5% investment restriction disappears

Through a process of drip-fed changes, the current investment restriction is that funds should not invest more than 5% of their net assets in other offshore funds except where such investments are in funds which are or could be certified as distributing. Where a chain of multi-tier investments in offshore funds exists there is a requirement to consider each tier.

Going forward it is proposed that there should be no investment restriction and the fund needs only to consider whether it has direct investments in other offshore funds - this is a positive change. As such, where reporting funds invest in other reporting funds this should be relatively straight-forward and without consequence. However where a reporting fund invests in a non-reporting fund the reporting fund has to either:

a) fair value this investment each period, effectively bringing in both realised and unrealised gains as income, which will then be taxed in the hands of UK investors perhaps without the supporting cashflow; or

b) gather enough information in relation to the underlying investee fund, so as to be able to provide information to their investors as if the investee fund were also reporting (a notional reporting fund).

In addition, there is not at present a *de-minimus* under which the requirement to fair value investments in underlying funds would not apply, unlike the current regime where effectively cumulative interests in non-distributing funds under 5% of the net asset value of the fund are disregarded for the purposes of distributor status until disposal.

This has the following impacts:

- Where a second tier offshore fund does not comply with the UK requirements and sufficient information cannot be gathered, not only is that investment treated under income tax rules in relation to gains, but in addition, no UK tax deferral until ultimate disposal is now achieved.
- If an investment is fair valued, and this fair value is taken to be reportable income to UK investors, the UK investor may have a very significant tax bill to settle without having received any cash.
- Care will again have to be taken through operation of a very complex attribution account to ensure that UK investors are not subject to double taxation on disposal of their investment in the reporting fund.
- Non-coterminous accounting period ends for the two offshore funds will continue to create difficulties, in relation to the attempt to fair value or gain sufficient information to treat the fund as a notional reporting fund.

A mark to market approach was considered for investment in non-distributing funds during a previous round of consultation on the offshore funds regime earlier this decade. A key concern was that the introduction of a mark to market approach could close the UK market to non-qualifying funds – one might consider why the conclusion would be different today, i.e. will the position going forward now mean that in practice only reporting fund of funds investing in other reporting funds will be able to distribute into the UK market?

If this were to be the ultimate conclusion this could have some interesting impacts. Firstly mixed offshore fund of fund structures would be extremely hard to operate from a UK reporting fund perspective, particularly when considering the attribution accounts necessary and the potential amount of deemed distributions received by UK investors. Therefore conceivably, if a fund is investing significantly in offshore funds which can't or won't be reporting, would it actually be better for that fund also to be non-reporting, as at least the UK investors would then still achieve deferral of tax as income until ultimate disposal?

Given the offshore funds regime is under consultation in conjunction with the proposed tax regime for UK authorised Funds of Alternative Investment Funds (FAIFs), it will be of great interest to see how the FAIFs regime develops in comparison.

The change in definition of an offshore fund

Prior to 2007, an offshore vehicle had to satisfy the conditions contained in the Financial Services and Markets Act 2000 (FSMA) to be a collective investment scheme (CIS) before it could be an offshore fund. Finance Act 2007 modified the definition of an offshore fund by including entities or arrangements that would otherwise constitute a CIS, but where an investor might reasonably expect to realise the value of the investment at any time with a period of seven years. This change was designed to include within the tax rules certain offshore investment arrangements that would not satisfy the condition for being a CIS under FSMA, because of a longer time horizon for realisation than that typically associated with a CIS.

Under the discussion paper, a stand-alone set of characteristics, loosely based on the FSMA concept of a CIS but potentially more wide-ranging, will define whether an offshore vehicle falls within the tax regime.

Importantly these characteristics look to identify those situations "where investors 'pool' their money to collectively invest in various types of assets where those assets are not managed by the investors themselves", but appear not to include any direct reference to what would be considered a traditionally open-ended structure.

If this definitional change is implemented, the industry will need to review (again) its fund offerings in detail to consider whether:

a) funds will be subject to the new regime; and

b) funds are invested in other entities which may now be subject to the new regime.

However, it is not currently clear how these characteristics will be applied – will a fund need to meet all criteria in order to be within the new rules, or will there be a balanced judgement approach? Further, more clarity is needed around key issues such as the property investment test, and whether the proposed rules will be retrospective or if grandfathering arrangements will apply.

Evidently the Treasury remains concerned that the scope of the offshore funds rules is still too narrow, despite the recent changes. Yet it would be entirely disadvantageous to the fund distribution market within the UK if the regime became too expensive and unwieldy, particularly bearing in mind the primary policy aim to create a level playing field between UK authorised funds and their offshore counterparts. Also, a substantial body of anti-avoidance legislation already exists to cover structures which are not traditional offshore collective investment schemes.

On a more positive note, under the consultation document, one area causing a significant administrative burden at present has been addressed. The scope of the current regime includes entities where by virtue of their fiscal transparency, income (and sometimes capital gains) flow directly to UK investors for tax purposes, as they arise from the underlying investments of the fund. Given that there should be no leakage from the UK tax net in such circumstances, such vehicles are now proposed to be outside the reporting fund regime. This will result in somewhat less of an administrative burden for managers of such entities and managers should consider whether and if this exemption could apply to their products.

So what conclusions can be drawn?

Can the proposed regime purport to achieve its aims? Regarding the issues discussed above, the removal of the need to physically distribute cash (and its associated complications around separate share classes and reinvestment mechanisms), as well as removal of the investment restriction, are clearly attractive features. However, the removal of the definition of an offshore fund from the regulatory definition, and the mark to market approach suggested for reporting funds investing into other non-reporting funds are matters for concern and should be the subject of full debate during the consultation period.

Another very important aspect of the proposals will be the basis upon which an offshore fund must report its income to UK investors and HMRC. This has the potential to create a significant administrative burden for fund promoters (as witnessed by the industry's experiences in Germany over the past few years). We will address this topic, as well as other features of the Treasury's proposals, as the consultation process continues.

Given the importance of the Treasury's proposals, fund managers, administrators and others involved in the asset management industry should actively consider engaging with HMRC on practical issues which will impact them. The consultation period ends on 9 January 2008, with draft legislation expected soon afterwards. The subject of transitional provisions has not been addressed in any detail in the discussion paper.

Contacts

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