

# Distribution of offshore funds into the UK

Luxembourg Funds  
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## Agenda

- Introduction
- Summary of current UK offshore funds regime
- The new offshore funds regime
- Impact on product structuring
  - Traditional Funds
  - Hedge Funds
  - Private Equity & Real Estate
- Impact for administrators

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## Introduction

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London
- Sarah White - Tax Manager Investment Management and Real Estate  
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## The Current Offshore Funds Regime

### **Aim of the Offshore Fund Rules**

- To prevent avoidance of UK tax through the use of offshore investment vehicles
- To prevent income being rolled up and accumulated, tax free in the fund until disposal by a UK investor
- To prevent the reclassification of income to capital (differential tax rate, capital losses, capital gains tax exemptions)

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## The Current Offshore Funds Regime

### **Where current offshore fund regime is relevant**

- Fund satisfies conditions in the Financial Services and Markets Act 2000 (“FSMA”) to be a ‘collective investment scheme’
- The investor has to have a ‘material interest’ in that fund
- Material interest = Portfolio investment realised within 7 years at MV of fund assets

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## The Current Offshore Funds Regime – (contd.)

### **Mechanics of current regime**

- Distinguishes between qualifying (or “distributing”) and non-qualifying (or “non-distributing”) funds.
- Qualifying funds should apply annually for “distributor status”.

### **UK Distributor Status Conditions**

- Distribution requirement 85% of income (higher of 85% of the fund’s UK equivalent profits or accounting income in fund)
- Annual retrospective filing to HMRC within 6 months of accounting period end
- Investment restriction – subject to certain exemptions a fund should not hold more than 5% of investment portfolio in other offshore funds

### **Impact of Not Obtaining Distributor Status**

- Fail for 1 period – investor taxed as income on entire realised gain

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## Implication of a being a Non-Qualifying Fund

Very important that funds obtain distributor status EVERY year



Failure to obtain distributor status (even for one period) will mean UK investors taxed as income in relation to whole gain on disposal

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# Current trends regarding UK tax status in the offshore fund market

Type of Fund	Seek Qualifying Fund status?	Reasons
<b>Traditional Funds</b>	Yes	<ul style="list-style-type: none"><li>•distributing funds/share classes</li><li>•Quasi-accumulation classes with appropriate re-investment mechanics</li></ul>
	No	<ul style="list-style-type: none"><li>•accumulating funds – retain cash</li></ul>
<b>Real Estate/Private Equity Funds</b>	No	<ul style="list-style-type: none"><li>•not an offshore fund</li><li>•no material interest</li></ul>
<b>Hedge Funds</b>	Generally no	<ul style="list-style-type: none"><li>•may not be an offshore fund</li><li>•Under UK tax concept of trading gains could be regarded as “income” – distribute annually</li><li>•decrease in AUM</li><li>•HNWI – no significant tax differential</li></ul>
<b>Fund of Funds</b>	No	<ul style="list-style-type: none"><li>•investment restriction</li></ul>

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## The Proposed Reporting Regime

### **UK Government stated aims**

- Reduce administrative burden and cost of compliance for managers in adhering to UK offshore funds regime
- No reduction of tax take for UK exchequer
- As far as possible provide parity of tax treatment between offshore and UK funds

## The Proposed Reporting Regime

### **Current status**

- Consultation paper released October 2007
- Next Steps consultation paper released March 2008
- Partial draft regulations released for consultation May 2008
- Comments due by 11 July 2008
- Further draft regulations expected September/October 2008
- Expected implementation date Spring 2009
- New regime expected to apply to current definition of an offshore fund until new definition enacted (expected in Finance Act 2009).
- Some important outstanding issues not yet considered in partial draft regulations

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## The Proposed Reporting Regime

### **Main changes**

1. Upfront approval / Investor elections
2. Removal of the investment restriction
3. Reporting income rather than cash distributions
4. Reporting mechanics
5. Breaches
6. Change in definition

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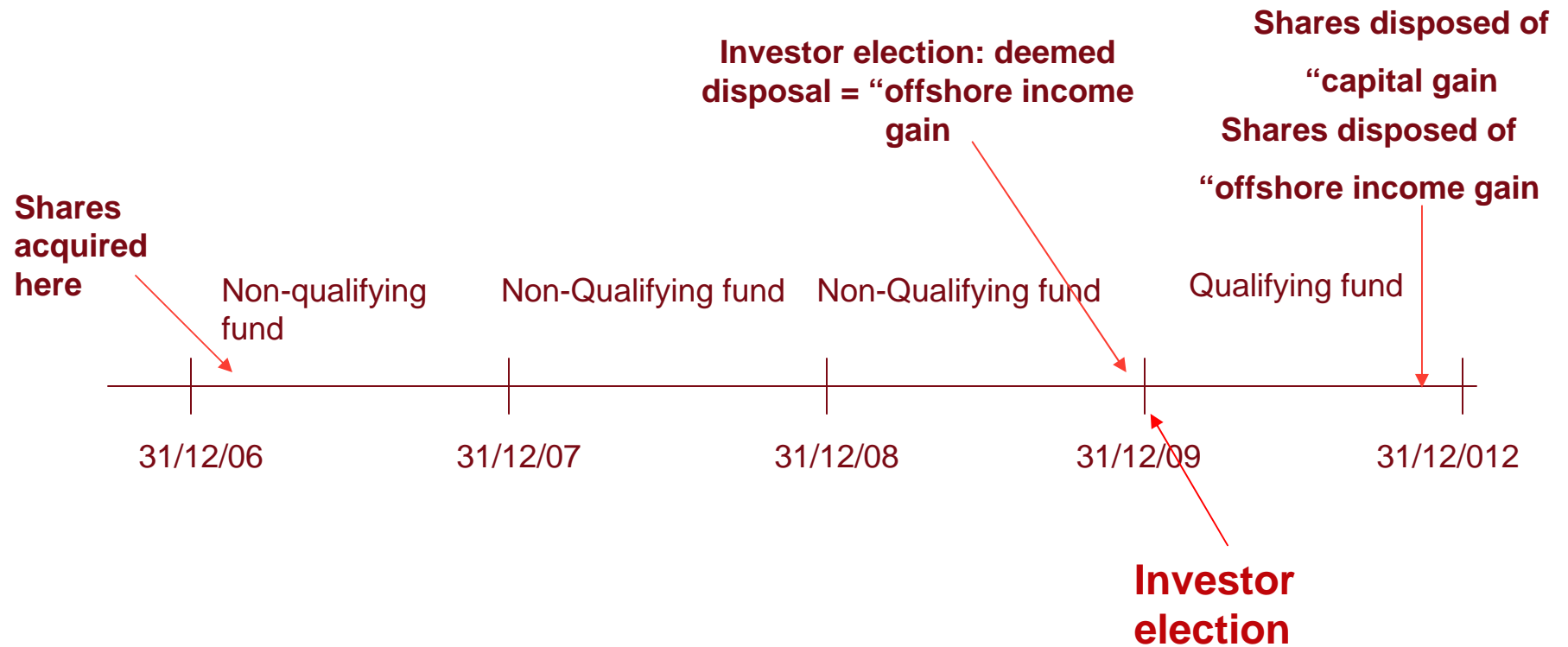
Some details...

## (1) Proposed upfront approval application

- Content stipulated in draft regulations
- Focus on fund accounting
- Timeframe
- New aspect – commercial purpose test
- Investor elections introduced

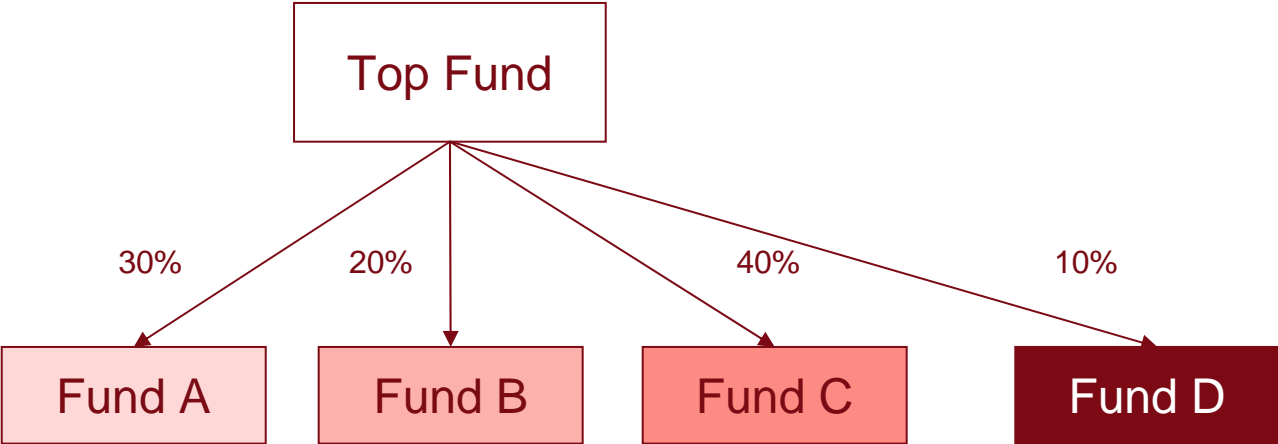
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### (1a) Non-qualifying to qualifying status – Investor Elections



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## (2) Removal of Investment Restriction



- Reporting
- Notional reporting
- Non-reporting – fair value basis
- Debt investments

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### (3) A reporting regime

- Fund no longer required to make physical cash distributions
- Fund must report 90% of its 'reportable income' to both HMRC and investors annually
- What is reportable income?
  - Financial statements GAAP
  - Certain adjustments required

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## (4) Reporting mechanics

### **Investor reporting**

- Information to be included as stipulated by draft regulations
- Communication with investors

### **Reporting to HMRC**

- Information required from a fund on an annual basis as stipulated by the draft regulations
- Additional information powers proposed

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## (5) Breaches

### **Consequences:**

- If breach minor, inadvertent and remedied without undue delay
- Significant breach

### **Areas of risk:**

- Information provision
- Calculation of reportable income

### **Major breach - Reporting Fund Status revoked**

- Where there is deliberate or repeated non-compliance
- Fund will permanently become a non-reporting fund
- It will not be allowed to re-apply for reporting status

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## (6) The Proposed Reporting Regime - Scope

**Characteristics as presently drafted identify an entity which:**

1. Is created under foreign law
2. Is not UK tax resident
3. Is managed by a fund manager – the investors do not have day to day control over management of the property
4. Creates rights in the nature of co-ownership where the investors are not taxed directly on their share if the underlying income
5. Has the purpose of investment of the co-owners' funds with the aim of spreading investment risk; and
6. Entitles investors to realise substantially the net asset value of its interest on realisation.

Characteristics taken from FSMA definition but potentially more wide ranging.

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(7) Where are we now?

Outstanding issues post partial draft regulations

## **Mechanics**

- No transitional or grandfathering provisions
- How investment through nominee accounts will be dealt with
- Procedures when cash distributions exceed reported income
- Banking secrecy / data protection

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(7) Where are we now?

Outstanding issues post partial draft regulations - cont

## **Reporting**

- Format of upfront approval application, as well as reporting to HMRC and investors

## **Reportable income calculation**

- No provisions covering equalisation
- Issues surrounding investments in other offshore funds
- How offshore accounting methodologies will be approved

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# Further UK tax changes under Finance Bill 2008: The taxation of UK investors into offshore funds

	Individuals		UK Funds		UK Pension Funds	
	Qualifying Fund (“QF”)	Non-Qualifying Fund (“NQF”)	QF	NQF	QF	NQF
<b>Dividend (taxed as income)</b>	<b>32.5% Annual</b> NB – no tax credit available	NA	<b>20% Annual</b>	NA	Exempt	Exempt
<b>Gain on redemption</b>	18% (taxed as capital)	<b>40% (Deferral but taxed as income)</b>	Exempt (as a capital gain)	<b>20% (taxed as income)</b>	Exempt	Exempt
<b>Preference</b>	<b>Qualifying Fund</b>		<b>Qualifying Fund</b>		<b>Neutral</b>	

- Separate rules apply to other investor types such as UK life companies and banks.
- Other offshore funds may also be interested in the UK tax status of the fund

## Distribution of offshore funds into the UK

# Likely future trends regarding UK tax status of offshore funds

Type of Fund	Seek QF status?	Reasons
<b>Traditional Funds</b>	Yes	<ul style="list-style-type: none"> <li>distributing funds/share classes</li> </ul>
	Yes	<ul style="list-style-type: none"> <li>accumulating funds – retain cash</li> </ul>
<b>Real Estate/Private Equity Funds</b>	?	<ul style="list-style-type: none"> <li>depends on new offshore fund definition</li> <li>depends on material interest</li> </ul>
<b>Hedge Funds</b>	Yes / No	<ul style="list-style-type: none"> <li>depends on new offshore fund definition</li> <li>depends on trading strategy gains regarded as “income” – distribute annually</li> <li>no decrease in AUM</li> <li>individuals significant tax differential</li> </ul>
<b>Fund of Funds</b>	Yes / No	<ul style="list-style-type: none"> <li>Depends on underlying fund status and compliance brand</li> </ul>

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## Impact of changes on traditional funds

### Review UK investor base

- do UK investors invest in my fund?
- do I want to attract UK investors?
- what is my investors tax profile/driver?
- will investors require cash distribution?

### Review funds

- is fund in scope?
- are funds trading or investing?
- do I need to establish/consolidate share classes?

### Review compliance obligations

- calculation of reportable income
- annual reporting to HMRC/investors
- impact of abolition of 5% test
- abolish dividend reinvestment schemes
- does fund have significant dry income?
- distribution to fund tax payment

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## Impact of changes on hedge funds

### Review UK investor base

- do UK investors invest in my fund?
- do UK based principals co-invest in fund?
- do I want to attract UK investment?

### Review funds

- is fund in scope? Is feeder structure affected?
- transparent funds – should a feeder be inserted?
- will any SPVs be in scope?
- grandfathering rules?
- are funds trading or investing?
- do I have mixed strategy funds?

### Review compliance obligations

#### Fund

- calculation of reportable income
- annual reporting to HMRC/investors
- is there significant dry income?
- distribution to fund tax payment?
- impact on investor lock-ins?

#### Investor

- should UK investors make election?

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## Impact of changes on private equity and real estate funds

### Review funds

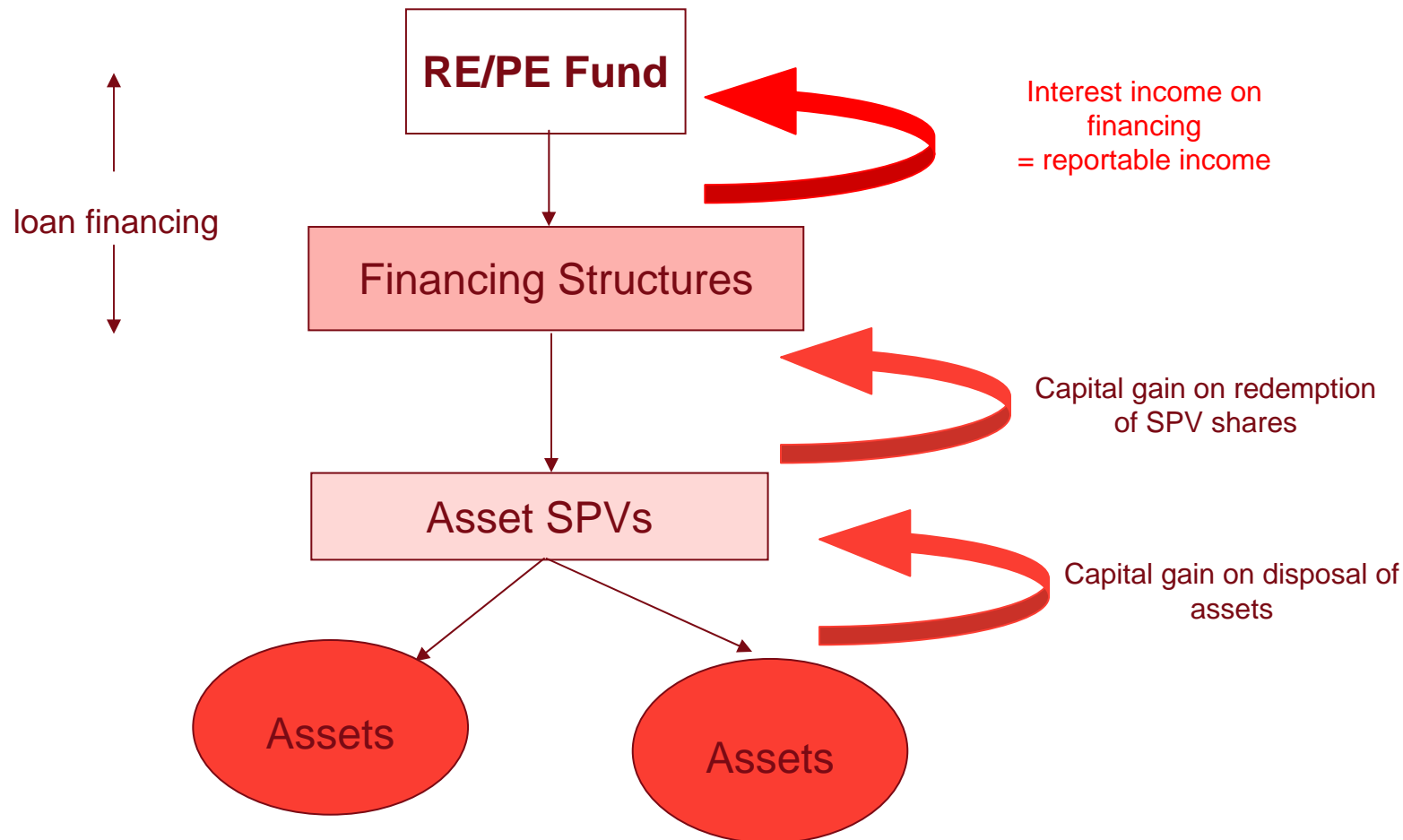
- is fund or feeder in scope?
- transparent funds – should a feeder be inserted?
- will any SPVs be in scope?
- grandfathering rules?
- review debt financing

### Review compliance obligations

- calculation of reportable income
- annual reporting to HMRC/investors
- is there significant dry income?
- distribution to fund tax payment?
- impact on investor lock-ins?

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# Impact of changes on private equity and real estate funds



NOTE - Exposure draft of new UK Statement of Recommended Practice for UK Authorised Funds – what impact might this have?

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## Impact of changes on administrators

### Review funds

- Will funds consolidate fund ranges – reporting on share class basis?
- is or will fund be in scope?
- transparent funds – production of UK tax information requires systems set ups
- Input into upfront approval process – focus on fund accounting & GAAP methodologies (compared to IFRS)
- Review investment strategies – are there bond or derivative instruments?
- Could there be significant capital adjustments for calculation of reportable income?

### Review compliance obligations

- Division of responsibilities with fund manager & custodians
- calculation of reportable income – systems set up to ensure correct data feed
- annual reporting to HMRC/investors – format & process
- is there significant dry income – attribution accounts for investors?
- distribution to fund tax payment?

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