

Keeping You Up To Date

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Offshore Funds Reform – Budget 2004

The details of the proposed reforms contained in the Finance Bill 2004 have just been published. The reforms should reduce compliance burden placed on the managers of distributing offshore funds and potentially allow more funds to qualify for distributing fund status.

The Finance Bill 2004 was published on 8 April 2004. It contains the details of the proposed reform of the offshore funds legislation. The changes primarily aim to simplify the rules governing distributing funds status.

Background

The offshore funds rules were introduced in 1984 in order to prevent a perceived unfair competitive advantage being gained by investors in offshore funds who were able to roll-up income within a fund. Unlike UK funds, the income realised on their investment is not charged annually to income tax and, without special rules, their accumulated income could have been subject to capital gains tax regime which was considerably more favourable than income tax. The offshore fund rules aim to redress the balance by providing that an investor in an offshore fund is subject to income tax on all his gains realised from an offshore fund where that fund does not have distributing status.

In order to obtain distributing status, the fund must be certified by the Board of the Inland Revenue as meeting certain investment restrictions and distributing at least 85 per cent of its income. Under the current rules, where a fund has separate classes of interest or several sub-funds, each of those classes of interest or sub-funds must meet the distribution requirement.

The Reforms

The reforms aim to simplify the requirements that must be met in order for a fund to qualify for distributing status by making the following changes to the rules:

- the calculation of income for the purposes of the distributing requirement is to be simplified;
- most of the investment restrictions are to be removed;
- sub-funds and classes of interest within a fund are to be able to qualify for distributing status in their own right.

update

Each of the proposed changes is discussed in more detail below.

1. Distribution requirement – calculation of income

Under the existing rules, a distributing fund must distribute at least 85 per cent of its income computed both on an accounts basis and on the basis of the amount on which it would be charged to tax if it were a company resident in the UK (“UK equivalent profits” or “UKEP”).

Currently, UKEP is measured on the basis of what would be the measure of profit chargeable to UK corporation tax with certain exemptions. One of the main exemptions is that income tax rules rather than corporation tax rules are used to measure profits from loan relationships and derivative contracts. The rules are being amended so that corporation tax rather than income tax rules will apply for the purposes of calculating income from loan relationships. This should enable the accounting treatment to be followed for tax purposes more closely in most cases.

A manager of an existing fund may opt to continue to operate under the current rules. However, once the fund changes to the new rules, the new rules will apply to all subsequent periods. The option is only available to the funds established on or before the date of Royal Assent to the Finance Bill 2004.

2. Investment Restrictions

The investment restrictions relating to offshore funds except for the 5 per cent test have been removed.

The 5 per cent test requires that a fund must not invest more than 5 per cent of its assets in other offshore funds unless those other funds qualify for distributing status. Therefore, going forward, the only investment restriction for offshore funds aiming to qualify for distributing funds status will be not to invest more than 5 per cent of their assets in other offshore funds unless those other offshore funds also distribute 85 per cent of their income and do not invest more than 5 per cent of their assets in other offshore funds.

3. Sub-funds and classes of interest to qualify for distributing fund status

Under the current regime, in order for a fund to qualify as a distributing fund, the distribution requirement must be followed in respect of each sub-fund or class of interest in the fund. This requirement is being abolished. Consequently, it will be possible for separate classes of interest or sub-funds in an umbrella fund to qualify for distributing status and for others not to qualify. A switch from a non-distributing class into a distributing class of interest will trigger an income tax charge.

Dechert Comment

Overall, the reforms should reduce the compliance burden placed on the managers of distributing funds and allow certain economies of scale although the reforms are not as far reaching as was expected at the start of the consultation process.

As a consequence of the reform, fund managers may be able to obtain economies of scale in some cases by taking advantage of the ability of individual sub-funds to qualify for distributing fund status and merging funds into a single umbrella fund.

Fund managers of non-distributing funds may wish consider the possibility of issuing new qualifying classes of interest in the existing non-qualifying funds to be more attractive to UK investors.

For Further Information

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