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UK - ALL CHANGE FOR OFFSHORE FUNDS?

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Introduction

As part of the announcements made in the recent pre-Budget Report, HM Revenue & Customs (HMRC) issued an important discussion paper entitled, “Offshore Funds” which aims to change key tax rules relevant to such funds from Summer 2008.

Current rules relating to offshore funds, treat gains made by UK investors holding “material interests” in such funds as income, unless the fund can obtain “distributing fund” status during the entire period in which the investor invests in the fund. The new proposals are intended to preserve a similar approach of taxing certain gains of investors as income, but the ground rules would change substantially. For these purposes, the definition of an offshore fund will change and the concept of a “distributing fund” is proposed to be replaced with a new concept of a “reporting fund”. There would no longer be a need to consider whether an interest in an offshore fund was a “material interest”. If implemented as currently proposed, these changes would be of great significance. Offshore funds would need to review whether they were willing and able to confer capital gains tax treatment on their investors as a reporting fund. The introduction of the single 18 percent rate of capital gains tax would increase the benefits to UK individual investors in reporting funds. However, it should also be noted that investors could suffer exposure to income tax liabilities on deemed income in excess of actual income distributions received from such a fund.

Many hedge funds have found it difficult to obtain distributing fund status and the proposed new rules may provide an opportunity for such hedge funds to come within the ambit of the new reporting fund regime. However, much will depend on how the rules designed to measure reportable income develop prior to implementation.

Proposals for new tax rules associated with the introduction, by the Financial Services Authority, of funds of alternative investment funds (FAIFs) will be developed in parallel with these proposals. Although this will delay the introduction of new tax rules for FAIFs, it is clearly desirable that any such rules enable onshore FAIFs to be competitive with the tax treatment of offshore funds.

Definition of “Offshore Fund”

A great deal of confusion was caused by the recent changes to the definition of an “offshore fund” introduced in the Finance Act 2007, which ultimately lead to HMRC issuing detailed guidance. HMRC are now proposing to amend the definition once again but this time to break away entirely from the definitions contained in the Financial Services and Markets Act 2000. Rather there will be a tax specific definition based around certain key characteristics. It is proposed that the rules would apply to a fund that is:

1. Created under foreign law;

2. not UK tax resident;

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3. managed by a fund manager such that the investors do not have day-to-day control over the management of the property (whether or not they have the right to be consulted or give directions);

4. creates rights in the nature of co-ownership but excluding those funds where investors are taxed directly on their share of the funds income;

5. has the purpose of investment of the owners' funds with the aim of spreading investment risk; and

6. entitles the investor to realise substantially the net asset value of its interest on realisation of its investment.

In some respects this new definition would widen the scope of funds currently caught by the existing legislation, although further HMRC guidance will no doubt be necessary. However, there is a very welcome simplification in removing funds which are tax transparent for income purposes. This will benefit offshore property unit trusts and also benefit most offshore partnerships, which could be of relevance to many hedge funds.

It is envisaged that sub-funds of umbrella funds would be treated, as at present, as separate offshore funds but HMRC are uncertain whether the ability to treat a separate class of share as an offshore fund needs to be retained. In any event, it is clear that preserving the ability to have a reporting class of share in a fund, that is otherwise non-reporting, would be desirable.

Reporting Funds

The discussion paper proposes to replace the requirement to distribute 85 percent of income for the purposes of the rules, as well as the 5 percent restriction on investments in other offshore funds, which are not capable of obtaining distributing fund status. Instead, a fund that elects to become a new reporting fund would be required each year to report to the fund investors their share of the reporting fund's income and provide information to HMRC to verify reportable income. In conjunction with this, is a proposal to consider the possibility of basing the measure of income solely on a suitable accounts-based method and abolish the UK equivalent profits (UKEP) calculation. A key advantage of such an approach would be to free funds from the need to calculate, solely for tax purposes, the fictitious UKEP income amount. It may also provide an opportunity to cut through the complex issue of the trading/investment distinction for tax purposes. This has acted as a barrier to many hedge funds under the existing rules due to the concern that "capital" profits would need to be distributed as "trading" income for tax purposes. Whilst an analysis of the various accounting rules would be essential, it may be that an accounting based method of calculating income could be implemented to produce a measure of income that focuses on true investment income and excludes profit derived from asset turnover. This might then enable more hedge funds to seek reporting fund status for its investors.

It is important to appreciate that, as the new regime is a reporting regime, it does *not* require the distribution of 100 percent (or indeed any percentage) of total income. It would, however, be the appropriate share of the full 100 percent of income (rather than 85 percent at present) that would need to be reported. Under the proposed new regime, investors may be taxed on more income than actually received by them. In order to avoid double taxation, HMRC propose that taxable reported "deemed" income be credited as further reinvestment cost, to reduce any gain on ultimate disposal of an investor's interest in the fund.

The new regime is also designed to bring greater certainty to investors. This would be achieved by submitting a prospectus in a form of an advance clearance application to enable HMRC to be satisfied that the fund is being established for bona fide commercial purposes. Following receipt of HMRC clearance, this information would then be disseminated to UK investors so that they are aware of their tax position from the outset.

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Non-Reporting Funds

Even under a new reporting regime, there will be offshore funds that are either unable or unwilling to seek reporting fund status. It is proposed that these funds be termed "non-reporting funds". UK investors in such funds will be treated in a similar way to those currently investing in non-distributing funds. The gain on an ultimate redemption of an interest in such a fund would be an income gain and taxed accordingly.

Fund of Funds

The proposed new rules would remove the need for a fund of funds to look through multiple tiers of investment funds to determine distributing fund status. Instead, it would rely on information produced by the reporting funds, in which it invests. In the case of an investment in a non-reporting fund, if information as to income cannot be obtained from the fund, the amount of income treated as reportable, for a reporting fund of funds, would be the fair value increase of the fund of funds investment in that fund. This could mean that investments in many hedge funds (on the assumption that they are non-reporting funds) remain unattractive for reporting funds of funds because of the unpredictable amount of deemed income that would need to be included in the reportable income of the fund of funds (and which would flow back to ultimate UK investors). It is also unclear how any loss in fair value might be dealt with under these rules.

FAIFs

In March this year, the FSA produced a consultation paper on a potential FAIF regime. A FAIF would be an onshore authorised investment fund of alternative investment funds. A FAIF would not be attractive to potential investors unless the tax rules enable such funds to be competitive with offshore funds of funds. Certainly, FAIFs would need to operate in an environment in which gains, made by the FAIF, on investments held in offshore funds, would not be taxable (offshore income gains would currently be taxable for a UK authorised investment fund). In addition, the proposed new tax rules, relating to offshore funds, might suggest that FAIF income could be taxed at investor level rather than in the FAIF, with a similar approach being taken to the calculation of income. It is reassuring that HMRC recognise the need for parallel work streams on these important topics.