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UNITED KINGDOM

New Offshore Funds Tax Rules Enter Into Effect May 27, 2011

By David Gubbay, Mark Stapleton, and Daniel Hawthorne, of Dechert LLP, London.

New regulations to amend the United Kingdom's tax regime for offshore funds will take effect on May 27, 2011. Managers of offshore funds with U.K. reporting fund status should pay particularly close attention to the final provisions regarding income equalisation and the opportunities and obligations these provisions present.

The United Kingdom's new tax regime for offshore funds and the associated reporting fund rules which enable U.K. resident investors to obtain favourable capital gains tax rates have been in place since December 2009 (*see analysis at WSLR, February 2010, page 30*). In February 2011, draft regulations were published setting out a series of proposed amendments to improve the practical operation of the rules (*see analysis by Mark Stapleton and Daniel Hawthorne, of Dechert LLP, London, at WSLR, May 2011, page 30*). The draft regulations placed particular emphasis on changes to the rules on income equalisation, with a view to eliminating the "last man standing" issue, which currently can arise where a reporting fund does not operate equalisation. Essentially, this could result in U.K. investors in the fund at the end of a reporting period being allocated a disproportionate amount of fund income for tax purposes, which would be especially unwelcome for certain investors, such as U.K. individuals, who pay a higher rate of tax on income than on capital gains.

In summary, the draft regulations proposed that some form of income equalisation or income adjustment be mandatory for reporting funds. The aim of such equalisation or income adjustment was broadly to allocate fund income across investors in a fairer manner, taking into account incoming or outgoing investors. A series of alternatives were available, ranging from "full equalisation", through plain "equalisation" to "income adjustment" on the basis of either accounting income or reported income. The suggestion of four alternative approaches to equalisation was, perhaps unsurprisingly, criticised for over-complexity.

Final Regulations Include Possibility to Do Nothing

The bad news coming out of the final regulations is that, in addition to the original four alternatives, there is now a fifth alternative. The good news, however, is that the fifth alternative is very simple—do nothing. Unlike the original proposals, the final regulations do not impose a mandatory adjustment of reportable income. Instead, it will be possible to apply no equalisation or income adjustment, and this additional flexibility and freedom is likely to be welcomed by many.

In the case of new reporting funds, managers must determine the method of equalisation (if any) the fund will apply. Relevant considerations will be the "last man standing" risk in light of the fund's investment policy (and the risk it may be trading) against investor expectation and the administrative burden of operating an equalisation or income adjustment. The decision must be notified to HM Revenue & Customs as a part of the fund's initial reporting fund application.

For funds already within the reporting fund regime, managers will have until May 27, 2012, to notify HM Revenue & Customs of the method of equalisation (if any) the fund will now apply. Importantly, a failure to make such a notification within this timeframe will

deem the fund to have elected to make income adjustments on the basis of reported income. "Do nothing" is not the default option. Perhaps counterintuitively, if the manager of a fund wants to do nothing as regards equalisation, it must initially do something, and submit the notification to achieve this outcome.

The new equalisation provisions will be welcomed by many managers and investors as a means of eliminating one of the principal downsides of reporting fund status. Others, on the other hand, will be grateful that this now remains only an opportunity and not an ongoing additional obligation. That said, even those wishing to choose the do nothing option must make a positive decision in this regard and notify HM Revenue & Customs accordingly. Reporting funds may also need to consider whether their prospectuses and/or U.K. marketing materials require amendment to reflect the position from May 27, 2011, and any decision made in relation to equalisation or income adjustment.

The new regulations also contain various other tax changes, as noted in our previous article. In particular, amendments have been made to the draft regulations to improve the exemption designed to prevent interests held in certain funds, predominantly private equity funds, from falling within the scope of the offshore fund rules.

The Offshore Funds (Tax) (Amendment) Regulations 2011 can be accessed at http://www.legislation.gov.uk/uksi/2011/1211/contents/made.

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