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Reporting fund status

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The offshore funds rules were originally enacted at a time, as now, when there was a substantial difference between the rates of income tax and capital gains tax, to prevent investors in offshore vehicles from converting income accumulated within the offshore vehicle into capital on the disposal of that interest. The offshore funds rules therefore provide that gains made on the disposal of an interest in an offshore fund are subject to income tax, rather than capital gains tax. The effect of this is to increase the tax payable on gains realised by the investor from 18% to 40% (potentially 50% from 6 April 2010) substantially reducing his net profit. The exception to this is for “distributor status funds”, those which distribute their income to investors on an annual basis – the income is taxed annually and the gain made on disposal is subject to capital gains tax treatment.

The government has signalled its intention to change the regime, in order to provide greater certainty to investors, simplify the rules and achieve parity with UK investors in UK authorised funds. The government has also taken the opportunity to widen the scope of the offshore fund definition, to catch a greater number of arrangements. The government has issued a number of consultation documents concerning the changes it intends to make to the offshore funds regime. In summary, it is intended to:

- Amend the definition of an offshore fund, so that it no longer relies on the definition contained in FSMA 2000. The effect of this is that the definition has been widened so that it may catch arrangements not previously within the definition of an offshore fund, most particularly closed-ended companies and contractual arrangements such as derivatives; and
- Change the distributor status regime to a reporting status regime, so that funds do not need to physically distribute income in order to benefit from capital gains tax treatment, although investors will be taxed as if they had received the distribution. Transitional rules have been proposed for investors currently holding offshore funds, with or without distributor status.

Under the current definition many offshore structures – such as closed-ended companies or structures where the investor is tied in for a fixed period of seven or more years – fall outside the definition of an offshore fund even if they are, in practice, administered in a similar way to other offshore vehicles which are caught.

The new rules are designed to catch many of the vehicles which were structured to fall outside of the existing definition. Under the new rules an offshore fund means

- a mutual fund constituted by a body corporate resident outside the UK or
- a mutual fund under which property is held on trust for participants by non-UK resident trustees or
- any other arrangements creating rights in the nature of co-ownership where the persons managing the property are resident outside the UK or the arrangements take effect by virtue of the law of a territory outside the UK.

A mutual fund broadly is one which meets conditions A to C.

- Condition A is that the purpose or effect of the arrangements is to enable participants to participate in the acquisition, holding, management or disposal of property or receive profits or income arising from the acquisition, holding, management or disposal of property. This is very similar to one of the limbs of the current definition of a collective investment scheme.
- Condition B is that the participants do not have day to day control of the management of the property. Again, this is similar to the current definition of a collective investment scheme.
- Condition C is that reasonable investors would expect to be able to realise an investment on a basis calculated entirely or almost entirely by reference to net asset value or an index of any description. This is different to the current definition in a number of important respects. Arrangements will not be a mutual fund for the purposes of condition C if a reasonable investor would expect to be able to realise net asset value *only* on a winding up, dissolution or termination *provided that* there are no arrangements in place for the fund to wound up by the end of a specified period or there are such arrangements but none of the assets held by the fund are income producing assets.

A broadening of the offshore fund definition?

It appears that the new definition of an offshore fund has led to a subtle broadening of its terms. The current requirement that an investor must hold a “material interest” in an offshore fund has been removed. This rule stated that an investor only held a material interest if it could reasonably be expected at the time that he acquired his interest he would be able to realise the value of his interest by surrender, transfer or otherwise over the next seven years. The reason this has been removed is to remove the disparity between investors in the same fund who acquired their interests at different times.

At present, closed ended companies are generally excluded from the definition, on the basis that the only companies which are collective investment schemes for the purposes of the FSMA definition are open-ended companies. However, although the consultation paper states that very few closed ended companies are intended to be caught by the legislation and that this will only be the case where they mimic open-ended companies, the new legislation represents a widening of the net. As set out above, where an investor only receives NAV on liquidation (which will be the case for a closed-ended company) and that fund is designed to wind up on a set date, they will only be outside the offshore funds rules if they invest in assets which are not income producing assets. This could be problematic for funds which are structured as limited life companies for commercial reasons (these types of funds automatically terminate after a set period so that there are no difficulties with the management receiving their carry).

Contractual arrangements

In addition, the guidance states that contractual arrangements that are considered to be neither bodies corporate nor tax transparent will be treated as open-ended bodies corporate. There is a concern that this would catch contractual arrangements such as derivatives and structured notes, since they will also meet conditions A to C.

Particular investment vehicles

The government has confirmed that tax transparent vehicles such as limited partnerships are outside the current offshore funds definition under general principles of taxation, since investors are subject to tax on income and gains as they arise. They will therefore also be outside the new offshore funds definition.

The December 2008 consultation document also refers to arrangements which are transparent for income tax purposes but not for capital gains tax purposes – this would include a Baker trust, a fund vehicle which is sometimes used for the holding of real estate.

Umbrella funds will not themselves be offshore funds. Each separate fund within an umbrella fund structure may be an offshore fund. Individual cells within a protected cell company may also be an offshore fund, as under the current rules.

The consultation document confirms that arrangements which are equivalent to UK- REITS will be outside the definition of an offshore fund, although an arrangement which is equivalent to a UK Property Authorised Investment Fund will be within the new definition.

At present, exchange traded funds (ETFs) are usually treated as offshore funds, as investors are able to realise close to net asset value from them on an exit. The consultation document states that it is intended that most ETFs will be offshore funds for the purposes of the new definition. However, if a listed arrangement results in the share value reflecting almost entirely the net asset value of the underlying assets due to commercial factors or market trends, rather than a pre-planned arrangement, this will not be within the definition of an offshore fund.

Insurance policies will remain excluded from the definition of an offshore fund and will still be subject to income tax under ITTOIA 2005.

Transitional provisions

Investors who currently hold investments which are outside the current offshore funds definition but which will be brought into the rules by the new definition will be subject to grandfathering provisions, so that any investments made before 1 October 2009 remain outside the new offshore funds rules. Investments made after 1 October 2009 will be subject to the revised definition
The government will ensure that the transitional rules are not abused.

Applying for reporting fund status

An offshore fund will be able to apply for approval in advance of the fund's first accounting period and HMRC will be able to give clearance that it meets the conditions for the regime. Reporting fund status will continue unless the fund no longer wishes to qualify or no longer meets the conditions. The fund will need to submit its accounts to HMRC annually for them to be audited.

Conclusion

Reporting Funds status maybe helpful to those funds whose strategies are not compatible with a policy of making regular distributions. However, it does mean the investors will need to balance the more favourable 18% capital gains tax rate on realisations against the "dry tax charge" on income.

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