

# Offshore funds: next steps

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March 2008



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# INTRODUCTION

**1.1** The UK tax regime for offshore funds was introduced in 1984. Broadly its purpose was to establish the tax treatment of activities that seek to use certain offshore funds to convert income flows into capital gains. As set out in *Offshore funds: a discussion paper*<sup>1</sup> issued alongside the 2007 Pre-Budget Report, the marketplace for funds has changed significantly since these rules were introduced. Commercial and European Union (EU) market developments have also produced an expansion in investment opportunities, including the increasing use of multi-tiered fund structures.

**1.2** In Budget 2007, the Government announced that it intended to continue to consult with industry on wider reform of the offshore funds regime to address tax barriers currently impacting on the development of offshore fund of funds. In addition, the Government stated that it intended to legislate for a modernised offshore funds tax regime in Finance Bill 2008.

**1.3** Alongside the 2007 Pre-Budget Report, the Government published *Offshore funds: a discussion paper* setting out its proposals for a modernised regime. The Government is grateful for and has carefully considered the responses from interested parties to that discussion paper.

**1.4** As stated in Budget 2007, and in the following discussion paper, one of the Government's main objectives in proposing changes to the offshore funds tax regime is to remove UK tax barriers to multi-tiered fund structures. At the same time the Government aims to:

- simplify the operation of the offshore funds tax regime;
- provide more certainty to UK investors and funds;
- achieve, to the extent possible, economic parity with the position of UK investors in UK authorised funds, whilst recognising that the Government has no taxing rights over the non-UK vehicles themselves;
- strengthen existing anti-avoidance rules so that UK investors who choose to invest into offshore funds do so based on commercial decisions and not to obtain unintended tax advantages; and
- implement a modernised regime at no increase in cost to the UK Exchequer.

**1.5** Budget 2008 announced that the Government was going to proceed with a modernised and simplified tax regime for offshore funds in Finance Bill 2008. Finance Bill 2008 therefore provides powers to enable a modernised regime to be introduced through secondary legislation. As also stated in Budget 2008 (see Budget Note 31), the Government has decided not to introduce a new definition of offshore fund in Finance Bill 2008. The Government intends to continue discussions with industry on the definition of offshore fund in order to introduce a new definition in Finance Bill 2009.

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<sup>1</sup> HM Treasury, October 2007

**1.6** The purpose of this document is to provide:

- a summary of the responses received to the discussion paper; and
- a summary of the Government's response to the key issues which were raised.

**1.7** There have been a number of key changes to the proposals resulting from responses to the discussion paper:

- first, as set out above, the Government intends to continue to discuss a new characteristics based definition of offshore fund with industry and introduce this in Finance Bill 2009 rather than Finance Bill 2008;
- second, the Government has listened to responses on the proposed 100 per cent reporting requirement and decided to allow for a 10 per cent margin for error with further provisions to cater for funds which only miss this by a small margin; and
- third, the Government will modify the rules for investors in offshore funds which either lose Reporting Fund status or become a Reporting Fund.

**1.8** It is also important to note that the regime will, as far as possible, be built around self-assessment principles. There will be an advance clearance procedure to allow funds to gain access to Reporting Fund status and, if the fund later ceases to be a Reporting Fund, there will not be a retrospective change to the tax status of the fund's investors unless a deliberately misleading or false application was made. There will also be provisions dealing with minor and inadvertent breaches of the Reporting Fund rules and an opportunity for a Reporting Fund to correct such errors without impacting on its status. If there is a major breach of the rules resulting in a fund being disqualified from Reporting Fund status, investors will face a revised tax treatment, but only from the date the fund is deemed to leave the regime.

**1.9** Draft regulations will be published shortly. These will be subject to the affirmative resolution procedure which allows for debate in the House of Commons. Comments will be invited on the draft regulations. Subject to responses, the Government intends to lay the regulations towards the end of the year with a view to the modernised regime coming into effect in spring 2009. Details of the start date and any necessary transitional provisions will be published after the period of consultation on the draft regulations.

**1.10** As the Government intends to put out draft regulations which will cover the points made in this paper shortly, the Government is not inviting comments at this stage. There will be an opportunity for people to give comments as part of the consultation on the draft regulations.

## Summary of responses

**1.11** The Government is grateful for the comments received from interested parties in respect of *Offshore funds: a discussion paper* published at the 2007 Pre-Budget Report.

**1.12** A summary of the key issues arising from the responses is contained in the following chapters:

Chapter 2 – Definition of ‘offshore fund’ for tax purposes;

Chapter 3 – Proposed framework for offshore funds;

Chapter 4 – Reporting fund investments into other offshore funds;

Chapter 5 – Proposed framework for investors.

**1.13** A list of respondents to the discussion paper can be found in Annex A of this document.



# 2

## DEFINITION OF 'OFFSHORE FUND' FOR TAX PURPOSES

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**2.1** *Offshore funds: a discussion paper* set out proposals for a new definition of an offshore fund for UK tax purposes. The aim of the proposals is to simplify the current rules and give more certainty to non-UK funds, their managers and investors. In introducing a new definition the Government's intention is also to counter tax advantages being obtained where an offshore arrangement is technically outside the current definition of an offshore fund but the arrangements are economically the same.

**2.2** The Government has carefully considered the responses received in respect of the definition and, as set out in paragraph 1.5 above, will continue discussions with industry in order to introduce a new definition in Finance Bill 2009.

**2.3** Finance Bill 2008 does not therefore provide for a new definition of an offshore fund. Sections 756A to 756C of the Income and Corporation Taxes Act 1988 (ICTA) have not been removed in Clause 38 of the Finance Bill which repeals all other parts of Chapter 5 Part 17 ICTA and introduces a power to make regulations to replace them. For legislative drafting reasons, this means that Clause 38 repeals the seven year 'material interest' rule with effect from a day to be appointed. However, because the Government does not intend to change the definition of offshore fund until Finance Bill 2009, the seven year 'material interest' rule will be replicated in the regulations.

**2.4** This chapter sets out a summary of responses to points for discussion on the definition of offshore fund.

### POINT 1 FOR DISCUSSION

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**2.5** Respondents were asked to comment on the proposals to move to a characteristics based definition for an offshore fund for UK tax purposes. The Government also invited comments on the proposed characteristics set out in the document, in particular the reference to an entitlement to 'realise substantially the net asset value'.

### Response

**2.6** Mixed responses were received on the proposals to move away from the regulatory definition. Most respondents wanted certainty in any definition of an offshore fund and some expressed concern that the proposed characteristics did not go far enough. Some respondents believed that the existing reliance on the regulatory definition gave them certainty and they did not want to move away from it, although others felt that it was ambiguous and that it currently causes uncertainty leading to inconsistent treatment within the industry.

**2.7** Some respondents wanted certainty that the revised definition did not encompass vehicles, including closed ended companies, which are outside the current definition. In addition, references were made to the HMRC guidance that was issued after Finance Act 2007, which was published in May 2007.<sup>1</sup>

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<sup>1</sup> *Definition of an offshore fund*, HM Revenue and Customs, May 2007 ([http://www.hmrc.gov.uk/manuals/osfgmanual/attachments/osfgapp3\\_Definition\\_of\\_an\\_Offshore\\_Fund.doc](http://www.hmrc.gov.uk/manuals/osfgmanual/attachments/osfgapp3_Definition_of_an_Offshore_Fund.doc))

**2.8** Several respondents requested that the '7 year material interest' rule or another time limit for realising net asset value be retained within the modernised regime.

**2.9** Mixed responses were received on the proposals for a characteristics based approach. Specific comments were made by some respondents on the wording of the characteristics included in the discussion paper, these included the requirement to be created under foreign law and creating rights in the nature of co-ownership. Many respondents questioned what would be considered 'substantial' and what constituted 'entitles' with regard to the characteristic '*entitles investors to realise substantially the net asset value of its interest on realisation*'.

**2.10** Many respondents wanted certainty as to whether their particular circumstances would remain in or out of the new definition and some requested that a list of entities be maintained by HMRC and specific guidance provided.

**2.11** Respondents also wanted certainty on the treatment of existing arrangements, in particular with regard to those which do not fall within the current definition of offshore fund but which would be brought into the regime under the proposed characteristics. Suggestions of 'grandfathering' existing arrangements were also raised by some respondents.

## POINT 2 FOR DISCUSSION

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**2.12** Views were invited on whether it is necessary to have a provision within the proposed regime similar to section 756C ICTA 1988, which states that a class of interest in an offshore fund (excluding umbrella funds) can be regarded as a separate offshore fund for the purpose of income attributable to that class.

### Response

**2.13** Most respondents wanted to replicate similar provisions for separate share classes within the modernised regime. Respondents preferred the retention of these provisions for a variety of reasons. These included the requirement to facilitate the reporting of income to UK investors and to enable managers to allocate the expense of complying with the UK requirements to the appropriate investors.

## POINT 3 FOR DISCUSSION

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**2.14** Views were invited on the inclusion within the definition of offshore funds of any trust with the characteristics as set out in paragraph 2.3 of the discussion paper. Views were particularly requested on whether, and if so why, such an approach would create uncertainty for offshore trust schemes.

### Response

**2.15** In principle most respondents did not consider that a separate definition of a unit trust scheme would be required. However, many respondents sought clarity on how the new characteristics would apply to certain trust arrangements, in particular 'Baker' trusts and 'Garland' trusts.

## POINT 4 FOR DISCUSSION

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**2.16** The Government welcomed views on the proposals in respect of other contractual arrangements and other tax transparent entities as well as non-tax transparent entities, bodies corporate and other legislation relying on the definition of an offshore fund.

### Response

**2.17** Many respondents agreed that the proposals for arrangements which are tax transparent for income and gains purposes should be outside the offshore funds definition, and some welcomed the certainty that this gave.

**2.18** Some respondents wanted to allow arrangements which are tax transparent for income and gains purposes, in particular the Luxembourg *fonds commun de placement* (FCP) and certain other contractual arrangements to be able to opt into the new offshore funds tax regime to facilitate UK investment. Several respondents stated that certain arrangements that are transparent for income and gains purposes are in fact very similar to a trust and should be treated accordingly. Some respondents suggested that vehicles which are transparent for income purposes, regardless as to whether opaque or transparent for gains purposes, should be automatically excluded from the offshore funds definition.

### Government response

**2.19** The Government will consider the responses to points 1-4 in discussions with industry on the new definition of an offshore fund.



# 3

## PROPOSED FRAMEWORK FOR OFFSHORE FUNDS

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**3.1** *Offshore funds: a discussion paper* outlined the framework for the proposed new regime from the perspective of the offshore fund.

**3.2** The Government has considered the responses received and has noted that respondents would like further detail on the proposals. This detail will be set out in the draft regulations which will be available shortly for comments. This chapter summarises the responses received and sets out the Government's response on certain key policy areas.

### POINT 5 FOR DISCUSSION

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**3.3** The Government invited views on the proposals for obtaining HMRC approval to become a Reporting Fund and the disclosure of Reporting Fund status.

#### Response

**3.4** Most respondents welcomed advance approval of Reporting Fund status which aims to allow an offshore fund to maintain that status until it is no longer required. Some respondents queried how this would work in practice in particular in respect of the interaction with the requirement to annually submit information to HMRC and any retention of separate class of interest provisions.

**3.5** Some respondents sought specific details in respect of the advanced approval process, including the timeframe for applications, the treatment of late applications and the time within which responses will be provided by HMRC.

**3.6** Some respondents sought further clarity on the proposed requirement for a Reporting Fund to have 'a genuine commercial purpose' and many respondents agreed that the requirement to disclose that the fund has Reporting Fund status will provide certainty to UK investors.

#### Government response

**3.7** The Government envisages that the proposed advance approval for Reporting Fund status will give certainty to funds and their investors. Unless the fund breaches certain conditions (see paragraphs 3.56 to 3.61), the offshore fund will remain within the Reporting Fund regime. It is only in the case where HMRC identifies that a Reporting Fund has submitted a deliberately misleading statement in its initial application or that application included a wilful omission, that the offshore fund will not be able to remain as a Reporting Fund and its status will be withdrawn retrospectively.

**3.8** In addition to the advance approval, the Reporting Fund will have an ongoing requirement to inform HMRC of any relevant changes to its operations which would have impacted its initial application (for example change of accounting standards). HMRC guidance will set out what is considered to be a relevant change.

**3.9** HMRC will issue a response to applications within 28 days of receipt of all specified information. The Government recognises that information on the offshore fund may change in the run up to its launch, therefore draft information can be provided in the initial application with final documentation being submitted within a

reasonable time period. Where changes which impact the application for Reporting Fund status are made (e.g. change of accounting standards or share classes), this may impact the timescale of the response from HMRC. Changes that are not significant to the UK Reporting Fund application will not affect the process.

**3.10** Further practical details of the advance approval procedure will be detailed in the draft regulations.

**3.11** An application for Reporting Fund status will be made by, or on behalf of the existing or proposed offshore fund. Where that offshore fund has more than one share class, the application should specify which classes are applying for Reporting Share Class status. If new classes of interest are issued in subsequent periods and these also wish to have Reporting Share Class status, the offshore fund should notify HMRC and declare that the conditions will be met in respect of that share class, rather than making a further full advanced clearance application.

**3.12** The Government does not intend to reproduce the current legislation that permits investors to obtain distributor status on behalf of a fund within the modernised Reporting Fund regime. The Government is, however, aware that certain UK investors may wish to have the ability to use the 'notional reporting funds' provisions. The Government will consider exploring the feasibility of the responses on this issue for investment by UK investors.

**3.13** As set out in the discussion paper, HMRC intends to issue guidance on the requirement for a Reporting Fund to have a genuine commercial purpose. The intention of this condition is to avoid unintended tax advantages being obtained, for example, by the artificial insertion of layers into a structure to defer income being reported to UK investors.

**3.14** It is intended that HMRC will produce, and regularly update, a list of offshore funds which have been approved as Reporting Funds. This will be similar to the current list held for qualifying offshore funds. HMRC also intend to explore the feasibility of an electronic application for Reporting Fund status.

## **POINT 6 FOR DISCUSSION**

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**3.15** The Government invited views on the requirement for a Reporting Fund to submit its audited financial statements to HMRC within six months of the date to which they are drawn up together with a calculation of its reported income.

### **Response**

**3.16** Since this proposal is similar to the current requirements, some respondents queried how this gave investors and funds more certainty than the current offshore fund regime requirements. Several respondents requested that a facility should be available to allow funds to submit this information to HMRC electronically.

### **Government response**

**3.17** The Government intends that Reporting Funds should submit their audited financial statements and reported income information to HMRC within six months of the date to which the financial statements are drawn up.

**3.18** This approach is similar to the current submission of information to HMRC. However, the key difference is that, as the offshore fund will have already been cleared as being a Reporting Fund, HMRC will not be using this information to 'approve' the fund.

**3.19** Instead, like the system for UK corporation tax self assessment, HMRC will consider the information received and, if any errors are identified or further information is required in respect of the period for which the information is provided, HMRC will correspond with the Reporting Fund within one year of complete information being received.

**3.20** If an error is found by HMRC which falls within the category of 'minor and inadvertent' there will be no requirement for the income reported for that year to be amended. If however the breach falls within the category of 'significant', the Reporting Fund will be required to make an additional report of income to investors to remain within the Reporting Fund regime. More information on breaches is set out in paragraphs 3.56 to 3.61 below.

## POINT 7 FOR DISCUSSION

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**3.21** The Government welcomed views on the proposed computation of reporting income, in particular to determine whether the proposed approach would reduce administrative burdens for funds or whether the retention of the UK Equivalents Profits (UKEP) calculation would be preferable.

**3.22** The Government also sought views on whether the ability to use other generally accepted accounting practices (GAAPs) would be welcome.

### Response

**3.23** Many respondents welcomed the proposals to explore an alternative to the existing calculation of income for a modernised offshore fund tax regime. Most respondents also welcomed the proposal to allow certain GAAPs other than UK GAAP and International Accounting Standards (IAS) for the purpose of the calculation. If this route were pursued, respondents suggested that HMRC should maintain a list of acceptable GAAPs.

**3.24** Some respondents agreed that an accounts based approach might be desirable but noted that additional administrative costs would be incurred, in particular in the initial periods of a new calculation. Some respondents wanted to retain the UKEP calculation for that reason.

**3.25** There were comments by some respondents on the difficulties in distinguishing between income and capital for certain transactions and some requests for that distinction to be removed.

**3.26** Some respondents gave detailed comments on equalisation, effective interest method and capital expenses. For equalisation, some respondents saw no reason to replicate the provision in the modernised regime while others wanted to retain the provisions. For effective interest, some respondents did not see any benefit in adjusting their accounts figures to align with UK GAAP or IAS accounting standards. Performance fees being treated as capital expenses was rejected in several responses.

## Government response

**3.27** The Government will not be removing the distinction between income and capital as part of the modernisation of the offshore funds tax regime. However, given that the balance of replies to the discussion paper were in favour of allowing the use of alternative GAAPs and were also in favour of moving towards a simplified calculation, the Government intends to continue to further explore the use of an alternative calculation. The Government recognises that any changes to the regime will mean funds incurring initial costs to implement a new calculation, but it envisages that the initial costs will be outweighed by the longer term benefits of an accounts based computation.

**3.28** As proposed in the discussion paper, the fund will be required to demonstrate to HMRC that the accounting basis figure proposed is a true alternative to the 'Total Recognised Income or Expense for the period', as set out in International Accounting Standards (IAS). In line with respondents suggestions, HMRC intends to maintain a list of alternative 'acceptable' GAAPs on its website.

**3.29** Where IAS or UK GAAP is used, the fund will be required use the effective interest method for the return on investments that are accounted for as, or in a similar way to interest. However, if the 'alternative acceptable GAAP' spreads the interest income over the expected holding of the investment, HMRC may accept that no further adjustments need to be made for the effective interest method. The Government envisages that this would be agreed by HMRC as part of the advance approval procedures. The fund will be required to demonstrate to HMRC that the alternative GAAPs methodology over the life of an investment will achieve an economically similar result for the investor. In particular that premiums, discounts and other 'non-coupon' returns known at the time of the acquisition are recognised from the outset as part of the interest income received and spread over the expected life of the investment.

**3.30** The Government recognises that not every offshore fund operates or wishes to operate equalisation. The existing tax regime includes provisions for those offshore funds which operate equalisation for the purpose of meeting the distribution test. The Government intends to incorporate equivalent provisions in the modernised regime to facilitate those funds that wish to operate equalisation and is doing so to simplify the language of the existing provisions. The draft regulations will simplify the language of the existing provision while aiming to achieve the same result.

**3.31** The draft regulations will require the offshore fund to make adjustments in the calculation for capital expenses. In line with respondents' suggestions, performance fees need only be treated as capital if a similar fee would have to be treated as capital in a UK authorised investment fund.

## POINT 8 FOR DISCUSSION

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**3.32** The Government sought views from commodity fund stakeholders as to whether similar rules to the current treatment are still required.

## Response

**3.33** The majority of respondents had no comments to make on this discussion point.

## Government response

**3.34** Given the lack of evidence to support the inclusion of commodity fund provisions, the Government does not intend to include similar provisions in the modernised offshore funds regime.

## POINT 9 FOR DISCUSSION

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**3.35** The Government welcomed views on the requirement to (a) annually report 100 per cent of the Reporting Fund's income and (b) allowing deemed income.

## Response

**3.36** Most respondents welcomed the deemed income approach. However, the majority of respondents expressed concern about the practicalities of being required to accurately report 100 per cent of income. These included issues on the rounding of income to be reported to UK investors and also around the 'margin for error' which offshore funds currently have under the 85 per cent distribution threshold. Most respondents requested that the limit be between 90 per cent and 95 per cent although some wanted to retain 85%.

**3.37** Some respondents requested clarification for the treatment of long and short accounting periods in addition to the alignment of reporting income where monthly and quarterly physical distributions are made.

**3.38** Respondents asked whether income had to be reported to all investors and how income was to be reported. Several respondents commented that any requirement to physically distribute tax vouchers to UK investors would be undesirable due to the additional administrative burden this would create.

## Government response

**3.39** As set out in the discussion paper, the Government intends to take forward the proposal to allow funds to report income to UK investors rather than requiring the offshore funds to make a physical distribution.

**3.40** In moving to a reporting rather than a distributing regime, the Government has also considered the level of income that a fund will be required to report. As part of this process, the Government has also taken into account the fact that, in the modernised regime, the calculation of income will be based upon accepted GAAP<sup>1</sup> and how reported income should be rounded.

**3.41** Following responses to the discussion paper and further consultation with industry, the Government recognises that the proposal (to require funds to report 100 per cent of income) would give rise to practical difficulties for funds arising from uncertainties in assessing the fund income to a sufficient degree of accuracy and certainty.

**3.42** The Government has therefore reconsidered its approach to the reporting of income. The first step in the process will be for a Reporting Fund to compute an amount of income which is available to report to its investors. This figure will be computed in accordance with the calculation described in paragraphs 3.27 to 3.31. In

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<sup>1</sup> UK GAAP, International Accounting Standards or an alternative GAAP as described in paragraph 3.18 of 'Offshore funds: a discussion paper'

arriving at this figure, the Reporting Fund will need to make adjustments to derive the amount of reported income from the financial statements (which will have been prepared in accordance with accepted GAAP). For example, adjusting for capital items. Having done this, the Reporting Fund will be required to report an income per share/unit figure to UK investors. The Government has listened to responses on the question of rounding the income to be reported to UK investors and will set out the requirements for the rounding of reporting income in the draft regulations.

**3.43** The Government recognises that, when arriving at the figure of reported income, the Reporting Fund may encounter practical difficulties when making the necessary adjustments to move from the accepted GAAP figure of total return<sup>2</sup> to the figure of reported income. In order to ensure that the modernised regime does not impose unnecessary administrative burdens, the Government therefore proposes to provide a 10 per cent margin for error for Reporting Funds. Details will be included in the draft regulations.

**3.44** If HMRC later discover that the calculation of the reported income figure is in error by more than 10 per cent but less than 15 per cent, then this will result in a minor breach. If the Reporting Fund or HMRC later discover that the reported income figure is in error by more than 15 per cent for any year, then this will be considered a significant breach of the rules. Paragraphs 3.56 – 3.61 set out more detail on the implications of breaching the offshore funds rules.

**3.45** The Government also recognises that separate provisions for funds which maintain a constant net asset value fund will be required and these will be included in the draft regulations.

**3.46** In line with the current offshore funds tax regime, the Government does not intend to require an offshore fund to send paper tax vouchers to its UK investors. However, in order to ensure that UK investors are aware of how much income to report every year on their self-assessment, the Government intends to set out minimum reporting requirements for offshore funds which elect into the Reporting Fund regime. The minimum requirements will be set out in the draft regulations and detailed in HMRC guidance. They will require the fund to disclose information on its website. In order to cater for investors who do not have internet access, the Government also proposes that offshore funds should include the necessary information or specific references to where to find such information in paper format, for example the annual investment statement. Where investments are held through a nominee or other third party, the regulations will require that nominee to provide the relevant information (or the details as to where the investor can obtain that relevant information) to its UK investors.

## POINT 10 FOR DISCUSSION

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**3.47** The Government welcomed views on the question of whether a *de minimis* provision was still required within a modernised regime.

### Response

**3.48** Some respondents agreed that, in theory, there seemed no necessity to retain a *de minimis* provision within a modernised tax regime for offshore funds. However, a *de*

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<sup>2</sup> The 'Total Recognised Income or Expense for the period' (or an exact equivalent such as the 'Total return before distribution' as computed under UK GAAP)

*minimis* provision was still considered to be important by the majority of respondents, given the proposal to move to a 100 per cent reporting requirement. Some respondents also called for a *de minimis* provision to be based upon gross, rather than net income.

### Government response

**3.49** The Government has considered the responses on a *de minimis* provision carefully. Given that the Government has decided to provide a 10 per cent margin for error for the calculation of reported income and will be implementing rounding provisions the Government does not intend to include a *de minimis* provision within the modernised regime. Where income is nil (or the rounding provisions result in 'nil') in a period, the fund will therefore be required to report 'nil' to investors.

### POINT 11 FOR DISCUSSION

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**3.50** The Government sought views on the proposal to remove the current 'reinvestment mechanics' requirements.

### Response

**3.51** Most respondents acknowledged that there was no requirement for the 'reinvestment mechanics' in a modernised regime where physical distributions were not mandatory.

### Government response

**3.52** Given the proposals to report rather than distribute income are being taken forward, the Government agrees that there is no requirement to retain the existing provisions for 'reinvestment mechanics'.

### POINT 12 FOR DISCUSSION

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**3.53** The Government welcomed views on the breaching of Reporting Fund conditions as set out in paragraphs 3.31 to 3.35 of the discussion paper.

### Response

**3.54** Most respondents welcomed the proposals that breaches which are minor, inadvertent and remedied without undue delay will not cause a Reporting Fund to permanently lose that status.

**3.55** Some respondents suggested that a Reporting Fund which lost its status should be able to re-apply for this status in future periods. This was considered to be particularly important for offshore funds that no longer had, but subsequently re-acquired, UK tax resident investors.

### Government response

**3.56** The Government has developed proposals for the breaching of conditions and these will be set out in the draft regulations. HMRC also intends to issue guidance in respect of 'minor and inadvertent breaches' and 'significant' breaches where a Reporting Fund defaults and loses that status.

**3.57** As set out in the discussion paper, the Government does not intend that a Reporting Fund will become a Non-Reporting Fund retrospectively. However, if an offshore fund has made a deliberately misleading statement or a wilful omission in the advance approval process, the fund's Reporting Fund status will be withdrawn with retrospective effect.

**3.58** Where breaches are 'minor or inadvertent', and not regularly repeated, it is intended that the Reporting Fund will remain within the regime on the understanding that the breach will be rectified. If a 'significant' breach or multiple breaches in a specified time period are identified, HMRC will inform the fund that Reporting Fund status will not be available from a future specified date.

**3.59** A breach of the conditions may have an impact on the income reported to investors. For 'minor and inadvertent' errors in the calculation of income, it is not intended that income reported in respect of that year will be amended. HMRC will notify the fund that any changes which need to be made as a result of that income calculation, must also be followed, as appropriate, in future calculations of income reported to UK investors. If breaches are considered 'significant' HMRC will request that the Reporting Fund restates its reported income for that period in order to retain its Reporting Fund status.

**3.60** To avoid unintended tax advantages arising, the Government does not intend to permit a Reporting Fund which loses that status through deliberate or repeated non-compliance from successfully re-applying for Reporting Fund status.

**3.61** But following responses received, the Government will explore the possibility of a fund being able to re-apply for Reporting Fund status where it had previously no longer wished to maintain that status. In exploring these proposals, consideration will be given to the associated proposals for the tax treatment of investors in such funds.

# 4

## REPORTING FUND INVESTMENTS INTO OTHER OFFSHORE FUNDS

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**4.1** *Offshore funds: a discussion paper* outlined the Government's proposals for a Reporting Fund which invests in other funds, including fund of fund structures.

### POINT 13 FOR DISCUSSION

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**4.2** The Government invited comments on the proposed treatment of a Reporting Fund investing into other Funds and, in particular, the proposal to treat a Non-Reporting Fund as a notional Reporting Fund.

### Response

**4.3** Respondents welcomed the proposals to abolish the existing 5 per cent investment restriction rule. Respondents also welcomed the fact that a Reporting Fund will not have to look further than the immediate, direct investment when computing reported income and complying with UK tax rules.

**4.4** Some respondents noted that the proposals for calculating income from investments into Non-Reporting Funds on a fair value basis will disadvantage some investors, as they will not benefit from being subject to capital gains tax (or corporation tax on chargeable gains) on the capital growth within those underlying investments. Many respondents were concerned that there would be no relief in future periods for falling investment values or that investors could be disadvantaged by this approach. Accordingly, some respondents suggested the return from a Non-Reporting Fund should be computed using an annual notional income yield based upon the underlying investment.

**4.5** Most respondents who commented welcomed the proposal to allow Reporting Funds to treat investment into Non-Reporting Funds, where certain conditions are met, to be calculated as if it were a Reporting Fund investment. Respondents also asked whether UK funds would be able to adopt the notional reporting fund rules where they invest into a Non-Reporting Fund.

### Government response

**4.6** The suggestion to move to a fair value basis was developed following informal discussions with industry stakeholders. It was put forward as a solution to allow the Government to remove the 5 per cent investment restriction rule without enabling UK investors to roll up income offshore while paying tax as if the income were a gain. The Government recognises that the fair value basis may result in capital growth being taxed as income. However, the Government intends to proceed with this fair value proposal, as it allows the removal of the current investment restriction while ensuring that the modernisation of the offshore funds regime is undertaken at no cost to the UK Exchequer. The regulations will also make provisions for falling investment values. The Government believes that this strikes a balance, between fairness for investors, complexity of legislation and anti-avoidance provisions. The Government will also consider whether, and if so how, an annual notional income yield based upon the underlying investment would work. Included in these considerations will be the experience of using this approach in other countries, the underlying asset class, foreign exchange, and the appropriate value on which to base the yield.

**4.7** The Government will also take forward the proposal to introduce a notional Reporting Fund as set out in the discussion paper. The extension of this availability for UK funds will be considered in conjunction with the Government's response to Point 5 for discussion (see paragraph 3.12).

# 5

## PROPOSED FRAMEWORK FOR INVESTORS

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**5.1** *Offshore funds: a discussion paper* outlined the proposals for the tax treatment of investors in Reporting and Non-Reporting Funds.

**5.2** The current offshore funds tax regime includes a specific rule which applies to UK investors in offshore funds in which they hold a 'material interest'. As the Government is not changing the definition of an offshore fund until Finance Bill 2009, the provisions of the seven year 'material interest' rule will be reproduced in the draft regulations made under the power in Finance Bill 2008.

**5.3** The Government has considered the responses received and, as a result has amended its proposals in respect of the reporting date for investors. The Government has also made significant changes to the proposals for investors in Reporting Funds which become Non-Reporting Funds and vice versa.

### POINT 14 FOR DISCUSSION

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**5.4** The Government welcomed comments on the proposed reporting date for investors.

#### Response

**5.5** Many respondents did not feel that a four month reporting date would provide sufficient time for financial statements to be audited and for income to be correctly computed and reported to UK investors. Respondents suggested that six months would be a more appropriate timescale.

**5.6** Some respondents also commented on the proposals to deter the late reporting of income by the proposals to treat 'late' income as arising on the date to which the Reporting Fund's financial statements are drawn up.

#### Government response

**5.7** In light of the responses received to the discussion paper the Government has decided to amend its original proposal by incorporating a six month reporting date period rather than the four months proposed in the discussion paper.

**5.8** The reporting date will, in most cases, remain as the date when income is reported to investors. The Government is seeking to achieve a practical solution to the six month reporting date for multi-tiered fund structures where income is reported late. The Government will also need to ensure that the rules cannot be manipulated by Reporting Funds deliberately reporting their income late. The Government will continue discussions with industry on this issue.

### POINT 15 FOR DISCUSSION

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**5.9** The Government invited comments on the proposed treatment of reported income from a Reporting Fund in the hands of UK individual investors.

## Response

**5.10** Most respondents thought that the proposals appeared reasonable providing that there was no double taxation for investors and that investors could still benefit from double tax relief, where appropriate. Some respondents asked how the calculations for investors should be computed.

## Government response

**5.11** As set out in the discussion paper, it is the Government's intention to ensure that UK investors will not be subject to double taxation if they receive income which has previously been subject to tax, either in whole or in part, as deemed income. Regardless as to whether income is physically paid or distributed, the UK investor will obtain relief for any foreign tax withheld at source under the normal rules.

**5.12** Details of the calculation will be included in draft regulations and HMRC intends to issue guidance, with example calculations, to assist taxpayers.

## POINT 16 FOR DISCUSSION

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**5.13** The Government invited comments on the proposed treatment of reported income from Reporting Funds in the hands of UK corporate investors.

## Response

**5.14** Respondents agreed with the proposals, which are identical to the current rules.

## Government response

**5.15** The Government intends to take forward the proposals as set out in the discussion paper.

## POINT 17 FOR DISCUSSION

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**5.16** The Government invited views on the proposed treatment of UK investors where the Reporting Fund loses that status and becomes a Non-Reporting Fund.

## Response

**5.17** Many respondents expressed concern that the proposals did not enable investors to benefit from capital gains treatment on the disposal of an investment which had accrued before the fund 'defaulted'. In addition, some respondents were concerned that investors would not be aware of the change of status in time to dispose of their investment before the status changed. Some respondents suggested deemed disposal mechanisms where the investor would compute a gain on disposal at the date the fund 'defaulted' with the tax liability then crystallising on the eventual disposal of the investment.

**5.18** Respondents welcomed the fact that the date on which the Reporting Fund loses that status will be a future and not a retrospective date.

## Government response

**5.19** The Government has carefully considered the proposals for a deemed disposal mechanism and intends to include an elective deemed disposal mechanism in the modernised regime. This is intended to work as described in the following paragraphs.

**5.20** If an investor makes a deemed disposal election, then the investor will benefit from the fund's original status as a Reporting Fund from the time the investor made the investment to the effective date the funds status changes from a Reporting Fund to a Non-Reporting Fund ('date of change RF-NRF').

**5.21** It is proposed that an election:

- will be optional;
- will be made by the investor<sup>1</sup> in an offshore fund which is changing its status from a Reporting Fund to a Non-Reporting Fund;
- may be made up to reasonable time period after the date of change RF-NRF;
- will require the investor to compute a deemed chargeable gain, benefiting from appropriate reliefs and exemptions, as at the date of change RF-NRF;
- will require the investor to pay tax on the deemed chargeable gain as if they had made a physical disposal as at the date of change RF-NRF; and
- will enable the investors to benefit from the Reporting Fund status before the date of change RF-NRF.

**5.22** The definition of a reasonable time period will be set out in the draft regulations. The draft regulations will also ensure that the 'bed and breakfasting' rules (section 106A of the Taxes and Capital Gains Act (TCGA) 1992) will be switched off in this circumstance.

**5.23** These proposals will ensure that investors making such an election are aware of their requirement to undertake the calculation and, where appropriate, include the deemed chargeable gain on their tax return and pay tax on the gain that has not been physically realised.

**5.24** If the investor does not make a deemed disposal election, when a Reporting Fund becomes a Non-Reporting Fund the UK investor will be treated as if they had always held a Non-Reporting Fund investment.

**5.25** Investors who do not make an election within a specified period of time will be treated as if they had always owned a Non-Reporting Fund investment when they dispose of their holding.

**5.26** The operational details of the deemed disposal election will be included in regulations and will be covered in HMRC guidance.

## POINT 18 FOR DISCUSSION

**5.27** The Government invited comments on the proposed treatment of individual investors in Non-Reporting Funds.

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<sup>1</sup> Including individuals, personal representatives or trustees

## Response

**5.28** Respondents welcomed the proposed treatment of individuals in Non-Reporting Funds, which is broadly the same as the current treatment of individuals in non-qualifying (distributing) funds.

## Government response

**5.29** The Government intends to retain the offshore income gains treatment for individual investment into Non-Reporting Funds.

**5.30** As set out in the discussion paper, the Government will also introduce a five year time limit for individuals who move abroad and realise their interest in an offshore fund. This is consistent with similar provisions in the chargeable gains rules.

## POINT 19 FOR DISCUSSION

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**5.31** The Government invited comments on the proposed treatment of UK corporate investors into Non-Reporting Funds.

## Response

**5.32** Most respondents were content with the proposed treatment which is broadly the same as the current treatment of corporate investments into non-qualifying (distributing) funds. One respondent suggested that there should be no offshore income gain calculation where the rules in section 212 TCGA 1992, which requires certain insurance companies to make a deemed disposal at market value, apply.

## Government response

**5.33** The Government intends to take forward the proposals as set out in the discussion paper. Changes are being made in Finance Bill 2008 (Schedule 17) which will ensure that the offshore income gain rules do not apply where section 212 TCGA 1992 applies to the interest in the offshore fund.

## POINT 20 FOR DISCUSSION

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**5.34** The Government invited comments on the proposed treatment of investors where a Non-Reporting Fund changes its status to become a Reporting Fund.

## Response

**5.35** Respondents expressed concern that investors would not be able to benefit from capital gains treatment from the date the fund became a Reporting Fund. As in the case where Reporting Funds become Non-Reporting Funds, a deemed disposal mechanism was suggested by some respondents.

## Government response

**5.36** The Government intends to address this issue by mirroring the treatment for a Reporting Fund which becomes a Non-Reporting Fund. It will therefore introduce an elective deemed disposal mechanism.

**5.37** If an investor makes a deemed disposal election, the investor will benefit from the fund's change in status from the effective date the fund status' changes from a Non-Reporting Fund to a Reporting Fund ('date of change NRF-RF').

**5.38** It is proposed that an election:

- will be optional;
- will be made by the investor<sup>2</sup> into an offshore fund which is changing its status from a Non-Reporting Fund to a Reporting Fund;
- may be made up to reasonable time period after the date of change NRF-RF;
- will require the investor to compute a deemed offshore income gain as at the date of change NRF-RF;
- will require the investor to pay tax on the deemed offshore income gain as if they had made a physical disposal as at the date of change NRF-RF; and
- will enable the investors to benefit from the Reporting Fund status after the date of change NRF-RF.

**5.39** The definition of a reasonable time period will be included in draft regulations. The draft regulations will also ensure that the 'bed and breakfasting' rules (section 106A TCGA 1992) will be switched off in this circumstance.

**5.40** These proposals will ensure that investors making such an election are aware of their requirement to undertake the calculation and, where appropriate, include the deemed offshore income gain on their tax return and pay tax on an offshore income gain not physically realised.

**5.41** If the investor does not make a deemed disposal election, when a Non-Reporting Fund becomes a Reporting Fund, the UK investor will be treated as if they had always held a Non-Reporting Fund investment.

**5.42** Investors who do not make an election within a specified period of time will be treated as if they had always owned a Non-Reporting Fund investment up to the time they disposal of their holding.

**5.43** The operational details of such a deemed disposal election will be included in regulations and HMRC intends to issue guidance.

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<sup>2</sup> Including individuals, personal representatives or trustees



# A

## LIST OF RESPONDENTS

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**A.1** The Government is very grateful to the individual respondent and the organisations listed below for their responses to *Offshore funds: a discussion paper*.

- Allen & Overy LLP
- Alternative Investment Management Association
- Association of International Accountants
- Association of Investment Companies
- Association of Private Clients Investment Managers and Stockbrokers
- Aviva plc and Morley Fund Management
- AXA UK
- Barclays Global Investors
- BDO Stoy Hayward LLP
- Blackrock Investment Management (UK) Limited
- Broadwalk Asset Management LLP
- Capital International SA
- CFS Taxation
- Deloitte
- Ernst & Young LLP
- Eversheds
- Fidelity International
- Franklin Templeton Investment Management Limited
- HBOS plc
- Herbert Smith LLP
- HSBC Group Investment Businesses
- ICAEW Tax Faculty
- Investment Management Association
- Irish Funds Industry Association
- JP Morgan Asset Management
- JP Morgan Worldwide Securities Services
- Kaye Scholer LLP
- Kinetic Partners LLP

- KPMG LLP
- The Law Society
- Linklaters LLP
- London Society of Chartered Accountants' Taxation Committee
- M&G
- PricewaterhouseCoopers LLP
- Schroder Investment Management Limited
- Simmons & Simmons







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