A GUIDE TO SOME OF THE PRINCIPAL PARTS OF THE OFFSHORE FUNDS RULES – PART 1

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Introduction

The "new" offshore funds regime, which came into force on 1 December 2009, is now nearly a year old. The purpose of this article, which is broken up into three instalments, is to consider the main aspects of the rules in some detail and to discuss some of the points and quirks that have arisen when they have been applied in practice.

This first instalment will explore the definition of "offshore fund"; Part II, which will appear in the next issue of the GITC Review, will introduce the Offshore Funds (Tax) Regulations 2009 and will look at "non-reporting funds"; and the final Part will look at "reporting funds" and the transitional provisions.

As a guide to the reader, the contents of the Parts are as follows:

1. The New Regime and the Definition of an "Offshore Fund"

The essence of the new regime, which is complex in its detail and wider than the one it replaced, is that the old "distributing fund" status has been replaced by "reporting fund" status, so that it is the latter that offshore funds within the scope of the new rules must now obtain in order to secure capital (as opposed to income) treatment for their investors. The key legislative provisions are now:

a). Part 8 of the Taxation (International and Other Provisions) Act 2010 ("TIOPA") (which defines an "offshore fund"); and

b). The Offshore Funds (Tax) Regulations 2009 (which set out the treatment of the "offshore fund" once it has been identified).

Also on the basic reading list is HMRC's Offshore Funds Manual ("OFM") which was published on 21 May 2010 and which contains some useful guidance on how HMRC interpret the new rules.[1]

With the reading list complete the next step is to work out what actually constitutes an "offshore fund". In a nutshell, an "offshore fund" is a non-UK vehicle in which investors pool their money in order to invest in various types of assets which are not managed by the investors themselves.

Previously, the definition of an "offshore fund" drew heavily on the definition of "collective investment scheme" found in section 235 of the Financial Services and Markets Act ("FSMA") 2000. The new definition, described as "characteristics-based", severs the link with the regulatory definition, although several elements of the old definition can be seen in the new one. The move to a "characteristics-based" approach is intended to reduce the opportunities for avoidance that were present when the FSMA 2000 "collective investment scheme" definition was used.

The new definition of an "offshore fund" is now found in section 355 of TIOPA, which provides as follows:

> (1) (a) a mutual fund constituted by a body corporate resident outside the United Kingdom,
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> (b) a mutual fund under which property is held on trust for the participants where the trustees of the property are not resident in the United Kingdom, or
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> (c) a mutual fund constituted by other arrangements that create rights in the nature of co-ownership where the arrangements take effect by virtue of the law of a territory outside the United Kingdom.
>
> (2) Subsection (1)(c) does not include a mutual fund constituted by two or more
>
> persons carrying on a trade or business in partnership.

> (3) In this section—
>
> “body corporate” does not include a limited liability partnership, and
>
> “co-ownership” is not restricted to the meaning of that term in the law of any part of the United Kingdom.
>
> (4) See also section 151W(b) of TCGA 1992, section 564U(b) of ITA 2007 and section 519(4)(b) of CTA 2009 (which have the effect that investment bond arrangements are not an offshore fund for the purposes of section 354).

So, one is concerned here with:

a. Non-resident bodies corporate (e.g. a hedge fund constituted by a company)

b. Non-resident trusts (e.g. a unit trust)

c. Co-ownership rights effected by foreign law (e.g. a Luxembourgish *fonds commun du placement*)

It is worth noting that c. does not include a mutual fund constituted by a partnership (because income arising to a standard, transparent partnership is taxed as arises and so is outside of the mischief intended to be countered by the rules). It is not impossible to conceive of circumstances in which such an arrangement could arguably come within limb b. where under the relevant foreign law the partnership assets are held on trust for the members, but it is considered that where those arragements are properly constituted as partnerships they ought not to fall within the section. Moreover, HMRC state categorically in their manual (OFM02110) that, “partnerships are specifically excluded from the meaning of an offshore fund”, which is not quite true on a literal reading but is nonetheless helpful.

Pausing there before looking at the definition of the concept of a “mutual fund”, it is worth noting that, as with the old regime, the new offshore funds rules make a marked distinction between UK funds on the one hand and non-UK funds on the other; this being the case it may be arguable that this difference in treatment offends EU Law, at least as far as EC-based funds are concerned.

a. Mutual funds

It will be seen from the foregoing that the term **“mutual fund”** is central to the definition of “offshore fund”. “Mutual fund” is defined in section 356 TIOPA:

> (1) In section 355 “mutual fund” means arrangements with respect to property of any description (including money) that meet conditions A, B and C.
>
> (2) Subsection (1) is subject—
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> (a) to the exceptions made by or under sections 357 and 359, and

> (b) to sections 360 and 361.
>
> (3) Condition A is that the purpose or effect of the arrangements is to enable the participants—
>
> (a) to participate in the acquisition, holding, management or disposal of the property, or
>
> (b) to receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.
>
> (4) Condition B is that the participants do not have day-to-day control of the management of the property.
>
> (5) For the purposes of condition B a participant does not have day-to-day control of the management of property by virtue of having a right to be consulted or to give directions.
>
> (6) Condition C is that, under the terms of the arrangements, a reasonable investor participating in the arrangements would expect to be able to realise all or part of an investment in the arrangements on a basis calculated entirely, or almost entirely, by reference to—
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> (a) the net asset value of the property that is the subject of the arrangements, or
>
> (b) an index of any description.
>
> (7) The Treasury may by regulations amend condition C.
>
> (8) Regulations under subsection (7) may only be made if a draft of the statutory instrument containing the regulations has been laid before and approved by a resolution of the House of Commons.

Thus, under the first limb of the definition, a "mutual fund" is an "arrangement" in respect of any form of property, the purpose or effect (so it applies even if the effect was not intended) of which is to enable the participants in the arrangement to participate in, or to receive profits or income (or sums paid therefrom) from, either the (i) acquisition, (ii) the holding, (iii) the management or (iv) the disposal of the property in question. Clearly, this limb is of very wide application, and would seem to cover pretty much every conceivable form of non-resident company, non-resident trust and co-ownership under foreign law (e.g. foreign co-ownership of rental property).

The definition is narrowed considerably by Condition B, which is that the participants must not have "day-to-day control" of the management of the property; however, the mere right to be consulted or to give directions does not amount to "day-to-day control". Condition B, therefore removes from the scope of the definition ordinary business partnerships, owner-managed companies, and many simple co-ownership arrangements where those involved retain day-to-day control. In this context, "participants" means the persons acting in the capacity of investors in a particular scheme, and "control" therefore means having control by way of holding rights as an investor. So, if the scheme manager held units or shares in the fund he managed then that alone would not prevent Condition B from being satisfied (see HMRC's OFM02710). Moreover, HMRC take the view that if even just one of the participants does not have the requisite control then Condition B can still be satisfied (*ibid*). This interpretation seems unduly strict and could give rise to difficulties in practice where, for example, one member has fewer management rights than others. A further interesting question arises in the situation where control is given to all investors but in practice some never exercise it. Is Condition B met in those circumstances? It would seem that the better view is that it is not met in such circumstances (and so the fund is not a "mutual fund"), since the test is concerned only with possession of control, not the actual exercise of it.

The third element of the definition requires that, under the terms of the "arrangement", a "reasonable investor" would expect to be able to realise his investment on a basis calculated entirely, or almost entirely, by reference to either the net asset value ("NAV") of the property concerned, or an index of any description.

"Reasonable investor" is not defined in the legislation. HMRC state in their guidance that they will assume that such an investor would have read the documentation and taken account of all additional material and communications of any nature whatsoever provided by the fund (OFM02720). One might ask whether, given the length of a standard investment fund offering memorandum, this is actually what a "reasonable", or at any rate, an "average", investor does; but that observation aside, it would seem that the "reasonable investor" requirement is intended to import a test akin to the "reasonable person" concept employed throughout the common law. In the view of the writer it is supposed to be an objective standard, coloured with the qualities that a "reasonable investor" would have. As we will see shortly, under the "exceptions|" heading, the presence of the "reasonable investor" requirement impacts considerably on the interpretation of the legislation.

As HMRC state in their Offshore Funds Manual that, "to 'expect', in this context, does not necessarily mean that an enforceable right exists, but it does mean that an investor could reasonably expect to rely on realisation as described" (OFM02715); one is therefore looking for both rights to a realisation at NAV as well arrangements that, although not structured as rights, are such that, taking the circumstances into account, a "reasonable investor" would expect have the choice to redeem at NAV should he or she so wish.

So what does "almost entirely by reference to NAV" mean? Understandably, HMRC will not specify what percentage deviation or variation from NAV on redemption arrangements will be considered not to meet Condition C, since it would give rise to opportunities for avoidance (OFM02725). This, of course, creates uncertainty, but it is considered that, in any event, any arrangements that sought to permit redemption at a value calculated on the basis of a deviation or variation from NAV would still be calculated by entirely or almost entirely by reference to NAV because the NAV is the reference point for the calculation. Instead, to avoid Condition C applying the calculation would need to be by reference to something else, or partly NAV and partly something else other than NAV.

b. Exceptions to the Meaning of "Mutual Fund" - Conditions D, E and F

The "mutual fund" definition is subject to further restriction in the form of section 357 TIOPA, which provides that arrangements are not a "mutual fund" where Condition D is met **and** Conditions E **or** F is met. Before looking at the conditions in detail, in summary it would seem that the carve outs are aimed at excluding two types of arrangement: (i) arrangements which do not really have the characteristics of collective investment schemes, and (ii) arrangements which will effectively produce a capital return or will produce an income return that will be taxable in the UK where relevant and which are not designed to produce an interest-like return.

Condition D is that the "reasonable investor" would **only** expect to be able realise his investment on the basis of NAV or an index in the event of the winding up, dissolution or termination of the arrangements. One important question that has arisen in practice in respect of this Condition is whether it will be met if the fund has within it a mechanism for a redemption at NAV, but that mechanism is not automatically available to the participants as of right, for example because access to it requires the consent of the directors of the fund. In other words, is Condition D concerned with the *probability* of a redemption at NAV or the mere *possibility* of a redemption at NAV?

Read literally, one might think that Condition D is concerned with the latter (hence the words "to be able…only"), so that even a contingent right to redemption at NAV would be enough to cause the fund to fail the Condition. However, by far the better interpretation of the Condition is that it is really looking at whether the participants have a *right* to redemption at NAV or have something that comes very close to being a right to that. So, for example, if the redemption at NAV is dependent on the directors' consent, but the participants have been told that consent will generally always be given upon request then Condition D will not be met, since a "reasonable investor" in that position would expect to be able to redeem at NAV. Conversely, where the right is conditional or contingent and there is nothing to lead a reasonable investor to expect that the condition is likely to be met or that the contingency is likely to be fulfilled then Condition D ought to be met. The reason why this interpretation is to be preferred is that if it were the case that the mere possibility (however remote) of redemption at NAV caused a fund to fail the condition then there would be no need for the "reasonable investor" concept in the section: the question would simply be whether the arrangements provide for the possibility of redemption at NAV otherwise than on a winding up, etc (see also OFM05250).

Condition D must be met in addition to one of either Conditions E or F.

Condition E is that the arrangements are not designed to wind up, dissolve or terminate on a date stated in or determinable under the arrangements, but it is provided that the mere fact that participants can vote to wind up the arrangements does not mean that they are so-designed. Moreover, HMRC state in their guidance that where the arrangements provide for a continuation vote or similar action to determine whether they will persist beyond a given date that will not, in itself, mean that Condition E is not met (OFM03110).

Condition F is more complicated. It is met where the arrangements *are* designed to wind up, etc, but the arrangements are not designed to produce a return for participants that equates, in substance, to interest and, in addition, either (s.358 TIOPA):

a. none of the assets held within the arrangements is a "relevant income-producing asset" (defined in s.358(2) as an asset which, if held by a UK resident, would generate taxable income (subject to the exceptions in s.358(3) and (4))); or

b. the participants are not entitled to any income (or benefit therefrom) from the assets; or

c. after deductions for "reasonable expenses",[2] income from the assets held within the arrangements is required to be paid or credited to the participants, and if the participants were UK resident individuals then income tax would be paid on that income.

It is Conditions D and E, together with Condition C, that ought to take most fixed share capital companies out of the definition of "offshore fund" since most will not have the characteristics of open-ended companies (i.e. flexible share capital that can expand or contract according to demand and where NAV determines the price on redemption of shares). A "reasonable investor" in a fixed share capital company would not expect to realise his investment on a basis calculated by reference to the NAV of the company unless the company was wound up and the proceeds of the company's net assets returned to its members.

Before leaving the subject of the definition of "offshore fund" it is worth bearing in mind that section 103A of the Taxation of Chargeable Gains Act ("TCGA") 1992 now treats interests in certain "offshore funds" as if the fund were a company and the participants in the fund held shares in a company for the purposes of the TCGA. It applies to all offshore funds other than corporate ones and unit trusts (i.e. those funds not already treated as companies under the TCGA). The section has effect for CGT from 1 December 2009 and for Corporation Tax purposes from 1 April 2010, although there is provision for an election to be made to back-date the treatment (see para.16 of Schedule 22 to FA 2009). It does not affect the treatment of the fund for income purposes, so the fund in question will otherwise remain tax transparent.

c. Umbrella Arrangements

As before, the new provisions have rules that apply where umbrella arrangements exist, for example, where the fund is constituted as a Luxembourgish SICAV umbrella fund or as a protected cell company.

Under section 363 TIOPA "umbrella arrangements" means arrangements which provide for separate pooling of the contributions of the participants and the profits or income out of which payments are made to them.

The offshore funds legislation has effect in respect of each discrete sub-fund or sub-class, with the umbrella arrangement itself being disregarded (s.360). This means that different funds within a single umbrella arrangement can have different treatments, and this can create opportunities for tax planning with some funds.

d. Arrangements Comprising More Than One Class of Interest

Where any arrangements comprise more than one class of interest, for example a corporate vehicle with different share classes or different security types, each class of interest is to be treated for the purposes of the offshore fund rules as a separate set of arrangements, and the “main arrangements” (i.e. the over-arching structure) are to be disregarded.

In relation to umbrella arrangements, it is possible that the discrete sub-funds and sub-interests recognised under section 360 will themselves be further broken down by section 361 if the sub-funds contain more than one class of interest (s.361(3)). Again, this phenomenon provides scope for tax planning within the fund.

Conclusion to Part I

It can be seen from the foregoing that the new definition of “offshore fund” is complex and involves the application of several tests of uncertain scope. Moreover, it should be remembered that the TIOPA tests just discussed only establish whether or not the arrangements in question constitute an “offshore fund”; they do not themselves supply the rules that actually make up the substance of the offshore funds code. That job is done by the Offshore Funds Regulations. In this regard it could be seen as something of an indictment on the new legislation that one has to trawl through a whole part of TIOPA 2010 and over 60 pages of HMRC guidance in order to decide whether or not the new Regulations will even apply. Perhaps this is an area already ripe for attention from the Office of Tax Simplification!

In any event, it is those Regulations, and particularly “non-reporting” fund status, that will be the focus of the next Part of this article.

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[1] References in the OFM to the Finance Act 2008 should be read as references to TIOPA, which replaced the former Act as from 1 April 2010.

[2] There is no definition of “reasonable expenses” within the legislation, but it is considered primarily to be a “release valve” rather than a form of anti-avoidance provision: a requirement to distribute all income received would very rarely be met and so the “reasonable expenses” let out lowers the hurdle. HMRC state, at OFM03130, that they will, “accept that expenses are reasonably deducted where they would, broadly, be deductible for a reporting fund in calculating its reportable income under Chapter 5 of The Offshore Funds (Tax) Regulations 2009. This would prevent, for example, capital items from being deducted”.