A GUIDE TO SOME OF THE PRINCIPAL PARTS OF THE OFFSHORE FUNDS RULES - PART II

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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.

In the last issue we looked at the definition of “offshore fund”. This second instalment will introduce the Offshore Funds (Tax) Regulations 2009 and will explore “non-reporting funds”. The final Part, which will appear in the next issue of the GITC Review, will look at “reporting funds” and the transitional provisions.

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

2. Introduction to the New Regulations Applying to Offshore Funds

In 2009 a new set of rules governing the taxation of Offshore Funds was introduced: the Offshore Funds (Tax) Regulations 2009, which apply from 1 December 2009.

The main difference between the new rules and the old ICTA rules is that there is no longer a requirement for an offshore fund to distribute its income in order for its participants to obtain chargeable gains treatment upon a disposal. Instead the participants will receive that treatment if the offshore fund reports its income to its participants (with the consequence that the participators will be taxed on that reported income). In effect, the new regime means that the participators are taxed on amounts that they might not yet have received.

The rules make a distinction between two types of offshore fund (reg.4):

(a) non-reporting funds and

(b) reporting funds.

The default rule is that an offshore fund is a non-reporting fund unless it is a fund to which Part 3 of the Regulations applies.

3. Non-reporting Funds

Part 2 of the Regulations concerns the treatment of Participants in Non-reporting Funds. The key operative provision is regulation 17, which creates the charge to tax. It provides that there is a charge to tax if (i) a person disposes of an asset, (ii) the asset is of a relevant type, and (iii) as a result of the disposal an offshore income gain arises to the person making the disposal.

Broadly speaking, the "assets" in question are:

(i) an interest in an offshore fund which is a non-reporting fund at the time of the disposal.

(ii) an interest in an offshore fund which, at the time of the disposal, is a reporting fund but which was previously a non-reporting fund. N.B. however, that if a regulation 48 ("clean slate") election has been made on the conversion of a non-reporting fund to a reporting fund (see below) or such an election could have been made but the interest was not standing at a gain, then regulation 17 will not apply.

Under regulation 18 the "offshore income gain" arising from the disposal of the asset in question is treated for **all the purposes of the Tax Acts** as income which arises at the time of the disposal. The deemed income is treated as arising to the person making the disposal.

Where the person in question is within the charge to income tax the tax is charged under Chapter 8 of Part 5 of ITTOIA 2005 (miscellaneous income) for the year of assessment in which the disposal is made. Where the person is within the scope of corporation tax the charge is under Chapter 8 of Part 10 of CTA 2009 (miscellaneous income) for the accounting period in which the disposal is made.

Regulation 19 applies where the person concerned is a remittance basis user and its effect is to treat the deemed income as "relevant foreign income". However, these rules do not apply where the participant is a beneficiary of a non-resident settlement, to which regulation 20 applies.

a. The Settlements Code and Section 87 TCGA

The first thing that regulation 20 does is to preclude a charge to tax under the settlements code (Chapter 5 of Part 5 of ITTOIA 2005) on an offshore income gain that arises to a settlement the trustees of which are neither resident in the UK nor ordinarily resident there. In other words, settlors of non-UK resident settlements do not have offshore income gains deemed to be theirs.

The next thing that regulation 20 does is to provide that the offshore income gains that arise to the trustees of a section 87 TCGA 1992 settlement are designated the "OIG amount" (reg.20(2)). The relevant provisions in the TCGA are then adjusted so that the OIG amounts can be attributed beneficiaries of the settlements in the same way as if they were capital gains.

It should be noted that the effect of regulation 20(4) is to ensure that offshore income gains are matched to capital payments out of a section 87 TCGA settlement before capital gains are matched. It should also be noted that the person to whom the offshore income gain arises is treated as the person making the disposal of the interest in the fund (reg.20(5)).

b. Section 13 TCGA

Linked to regulation 20 is regulation 24, which has the effect of applying Part 2 of the Regulations to section 13 TCGA 1992 so that offshore income gains arising to a non-resident, but otherwise close, company are apportioned to its UK resident participators. In the usual way, if an offshore income gain arises to a non-UK resident company which is held by non-UK resident trustees the offshore income gain is treated as arising in the settlement so that it can be apportioned to relevant beneficiaries under section 87 TCGA (as modified, see above).

c. Transfers of Assets Abroad

Regulation 21 is concerned with the interaction of the offshore funds rules and the transfer of assets abroad provisions (ss.720, 731 ITA 2007). It provides that sections 720 and 731 apply as if the offshore income gain arising to the non-UK resident were income. This treatment is disapplied in relation to an offshore income gain if it is apportioned under section 13 TCGA (as modified) (reg.21(3))). This treatment is also disapplied in relation to all or part of an offshore income gain that has been treated under regulation 20 (Application to gains of non-resident settlements) as arising in a tax year to a person (reg.21(5)). Moreover, if an offshore income gain is treated as arising under ss.720 or 731 ITA 2007 in a tax year then the "OIG amount" for section 87 TCGA purposes is reduced accordingly (reg.21(6)).

d. Key Ancillary Provisions

Further key provisions are to be found in regulations 22 and 23. Those regulations provide that:

- (By modification of s.2(1) TCGA) a person is chargeable to tax on offshore income gains arising during a year of assessment for any part of which they are UK resident or ordinarily UK resident (Reg.22(1)(a)).

- (By modification of ss.10 and 10B TCGA) a person carrying on a business in the UK through a branch or agency or a UK permanent establishment is chargeable to tax on offshore income gains arising on the disposal of a holding in an offshore fund if the holding was held for the purposes of the UK branch, agency or permanent establishment (reg.22(1)(b)(c)).

- (By modification of s.10A TCGA) an individual who is "temporarily non-resident" (as defined in s.10A TCGA) is chargeable to income tax on offshore gains arising during the period of temporary non-residence in the year of return to the UK (reg.23).

e. Exceptions from Charge

Under regulation 25 there is no liability to tax under regulation 17 if one of the following situations applies:

1. Where the participant must treat the interest in the fund as a deemed loan relationship (under Chapter 3 of Part 6 of CTA 2009 (OEICs, unit trusts and offshore funds)). In this scenario income derived from the holding of the interest and any increase in the fair value of the interest will be taxed as a credit under the loan relationship rules. In such a case there is no need for the offshore funds rules to apply since there will be no income roll-up.

2. Where the participant must treat the interest as a derivative contract (under Part 7 CTA 2009). Again, the participant will be taxed on credits arising from increases in the fair value of its interest for as long as it is held and so there is no role for the offshore fund rules.

3. For the same reasons, where the interest is an intangible fixed asset (under Part 8 CTA 2009).

4. Where the interest consists of excluded indexed securities (as defined in s.433 ITTOIA 2005).

5. Where the interest is a right arising under a policy of insurance.

Regulation 26 provides that there is no liability to tax under regulation 17 where the interest in the fund is trading stock or is otherwise taken into account in computing the profits of a trade (i.e. so that the disposal of the interest will give rise to an income (rather than capital) profit (or loss)).

Where the interest in the fund is a non-participating loan there is no liability under regulation 17 (reg.29).

On 28 February 2011 HMRC published a full draft of their proposed amendments to the Offshore Funds (Tax) Regulations 2009. One of these proposed amendments (reg.31A) involves a further exception to the charge under regulation 17 to be known as the “unlisted trading company exception”. This is to apply where the disposal is of an interest in an offshore fund, and where throughout the period during which the interest was held and at the time of disposal at least 90% of the value of the assets of the fund consisted of holdings in “qualifying companies”.

For these purposes a “qualifying company” means a “trading company” or the holding company of a “trading group” or a “trading subgroup” (all as defined), the shares of which are not listed on a recognised stock exchange or admitted to trading on a regulated market. It is understood that this exception is intended to tackle the concerns of the private equity industry that many companies held by private equity funds might fall within the offshore funds regime.

f. Transparent Funds

Subject to two exceptions, under regulation 29 no liability to tax arises if the disposal in question is of an interest in an offshore fund (constituted otherwise than as a body corporate) and the fund is a “transparent fund” (defined in regulation 11 as a fund whose participants, if they were UK resident individuals, would be chargeable to income tax as “relevant foreign income” on all sums referable to their interests).

The first departure from the exception applies where the transparent offshore fund has at any time held interests in other non-reporting funds and those interests amounted to more than 5% by value of the transparent fund’s assets. The reasoning behind this exception is that, without it, it would be possible to roll-up income in the underlying non-reporting fund.

The second departure from the exception applies where there is a disposal of an interest in a transparent fund, the fund is a non-reporting fund and the fund does not provide its investors with enough information to enable them to meet their UK tax obligations.

It is also worth noting regulation 16, which applies where a non-reporting transparent fund holds an interest in a reporting fund. The excess of reported income over income actually arising to the participators (see reg.94(2)) is treated as additional income of the participants in the transparent fund in proportion to their rights and is charged to tax as "relevant foreign income" (s.830 ITTOIA 2005) in the case of a person chargeable to income tax and as "miscellaneous income" (Chapter 8 of Part 10 of CTA 2009) in the case of a company within the charge to corporation tax.

g. Existing Holdings as at 1 December 2009

Some participators will have acquired their interest in the fund before the new rules took effect, when the definition of "offshore fund" was narrower. Regulation 30, therefore, provides an exception to tax in circumstances where the participator acquired their interest before 1 December 2009 or pursuant to rights acquired by an agreement entered into before 30 April 2009 and that interest was not a "material interest in an offshore fund" (as defined in s.759 ICTA).

h. Disposals of Interests in Non-Reporting Funds

Chapter 4 of Part 2 is where the provisions concerned with the mechanics of the disposal of interests in non-reporting funds are found. At their heart is the basic rule as to the meaning of "disposal", which is that used for capital gains tax purposes. Regulation 33 states that:

> "(1) There is a disposal of an asset for the purposes of these Regulations if there would be a disposal of an asset for the purposes of TCGA 1992
>
> (2) Paragraph (1) is subject to the following provisions of this Chapter."

The upshot of regulation 33 is that, subject to the provisions mentioned below, all of the learning on the meaning of the term "disposal", which is not itself defined in the TCGA, is incorporated into the offshore funds rules, as are all of the legislative rules on deemed disposals and part disposals. This means that when considering whether there is a charge to tax under the new offshore fund provisions one must approach the analysis as if one were applying the CGT rules (as modified).

The standard CGT position is modified by the "Further Provisions" in Chapter 4 of Part 2. Those provisions concern death, corporate reconstructions and corporate reorganisations. Looking at them in turn:

<u>Death (reg.34)</u> – contrary to the usual CGT death rule (i.e. the "free" base cost uplift), where a person dies and the assets of which he was "competent to dispose" (see s.62(10) TCGA) at the time of his death include an interest in a non-reporting fund then he is deemed to have disposed of any such interest to his personal representatives for a consideration equal to the market value of the interest at that time.

<u>Corporate Reconstructions (regs 35 and 36)</u> – in order to prevent the sheltering of offshore income gains, sections 135 and 136 TCGA are disapplied where the reconstruction involves an exchange of an interest in a non-reporting fund for an interest in a reporting fund. In such a case the exchange is treated as a market value disposal of the interest in the non-reporting fund.

Corporate Reorganisations (reg.37) – section 127 TCGA (equation of holdings in a reorganisation) is disapplied (and so an exchange will amount to a disposal of the old holding at market value) if four conditions are met. Broadly speaking, the conditions apply to exchanges of different classes of interest (which, under reg.6 are treated as discrete funds) within the same fund where the exchange is of an interest in a non-reporting fund for one in a reporting fund.

i. Computation: Part 2, Chapter 5

The computation of the "offshore income gain" that will be charged to tax is expressed to be equal to the "basic gain" (reg.38), which is essentially the gain that would arise under the TGCA (regs 39(1) and (2)). Again, this imports all of the existing learning on computation of gains for capital gains tax purposes. Any indexation allowance is not taken into account (reg.39(2)(b)).

The charge on the offshore income gain is in most cases, therefore, going to be the difference between the base cost of the interest and the consideration for the disposal.

Rather unsportingly, according to regulation 42(1), if the effect of the computation is to produce a loss then the "basic gain" is nil. As if to rub it in, regulation 42(3) provides that "accordingly, for the purposes of these Regulations, no loss is to be treated as arising on the disposal". This means that whilst any gains can be charged as income, any losses can only be relieved as capital: if investors think that that mismatch is unfair then they are right.

There is a special rule in place (reg.43) to deal with the position where a participator holds an interest in a fund that did not constitute a "material interest" in an offshore fund under section 759 ICTA but then acquires further rights in the fund after 1 December 2009. When this happens the two different holdings are treated as being of different classes so that section 104 TCGA (share pooling) will not apply. In addition, the pre-1 December 2009 interests are treated as being disposed of before the post-1 December 2009.

Further computational provisions are to be found in Chapter 6 of Part 2. Their purpose is to prevent double taxation on the occasion of a disposal that gives rise to both an offshore income gain and a chargeable gain. This is achieved by deducting the amount of the offshore income gain from the amount received for the CGT disposal. There are other specific rules dealing with adjustments to section 162 TCGA (roll-over relief for the transfer of a business in consideration of shares) and section 128 TCGA (consideration given or received for new holding on a reorganisation).

j. Conversion of a fund from Non-reporting into a Reporting Fund – the "Clean Slate" Election

An offshore fund that is non-reporting may wish to switch to reporting status in order that its participants can enjoy the benefits that such status brings (see reg.52). When this occurs a participant is presented with an opportunity, under regulation 48, to elect to be treated as having disposed of his interest in the non-reporting fund at market value on the "disposal date" (as defined) and as having acquired his interest in the reporting fund at the beginning of the reporting fund's first period of account. Put another way, the participator can start with a "clean slate" after the fund has attained reporting status. It is important to note, however, that no election can be made unless the offshore income gain arising on the deemed disposal is greater than zero.

Conclusion to Part II

As with the old "non-distributing" funds regime, the essential aim of the non-reporting fund rules is to prevent a taxpayer from gaining a tax advantage by rolling up income in an offshore fund and then disposing of his interest in the fund as capital. That being the case then, unless the interest in the fund can be structured so as to fall outside the definition of "offshore fund", the significant difference between the income tax "additional rate" of 50% and the top rate of CGT (at 28%) means that holding an interest in a reporting fund can be a more attractive prospect for the investor, all other things being equal. However, being in the reporting fund regime has pros and cons for both the fund and its investors, as we will see in the final part.