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

by Michael Jones

Introduction

The "new" offshore funds regime, which came into force on 1 December 2009, is now nearly two years 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 an introduction to the Offshore Funds (Tax) Regulations 2009 and explored "non-reporting funds". This third and final instalment will look at "reporting funds" and the transitional provisions.

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

4. Reporting Funds

Reporting funds take the place of distributing funds in the new regime. We will see that, in exchange for paying income tax on the income arising during the life of the fund, participants will have any gain on their investment taxed as capital.

According to regulation 50, a "reporting fund" is an offshore fund to which Part 3 of the Regulations applies. In order to become a reporting fund an application must be made for Part 3 to apply.

a. Constant NAV Funds

It should be noted that the Regulations relating to reporting funds are adjusted when the fund in question is a "constant NAV fund", that is a fund the net asset value of which does not fluctuate significantly. The regime as applied to a constant NAV fund is less onerous in terms of reporting requirements, but the fund must notify HMRC if it ceases to have "constant NAV" (regs 118 - 124).

b. Applications for Reporting Status

The application must be made by the manager, or other person who has or is expected to have day to day control of the property of the fund. The fund must be an "eligible offshore fund", which means an offshore fund which is not a "guaranteed return fund" (as defined in reg.9). It is possible for an application to be made in respect of a fund not yet formed (reg.51).

Regulation 53 prescribes what is to be included in an application and regulation 54 provides rules about the form, timing and withdrawal of the application.

Upon receipt of the application HMRC have 28 days in which to give notice to the maker of the application that HMRC (i) accept the application, (ii) reject the application, or (iii) require further information. If HMRC require further information, they must inform the applicant whether they accept or reject the application within 28 days of their receipt of the further information (reg.55).

Should HMRC reject an application the applicant may make an appeal pursuant to regulation 56. Notice of appeal must be given to HMRC within 42 days beginning with the date notice of rejection is given.

Amendments made to the Regulations with effect from 27 May 2011 introduce provisions relating to equalisation arrangements (as defined, somewhat unhelpfully, in reg.50A), including new regulation 56A, which provision allows fund managers to amend their initial application in relation to whether and if so to what extent the fund will operate equalisation arrangements or income adjustments (i.e. the matters within reg.53(1)(h) to (l)). It is to be noted that HMRC will not accept an amendment application if they consider that it is has been made otherwise than for commercial or administrative reasons (reg.56A(6)(a)). The manager is given a right of appeal against a rejection of an amendment application (reg.56B).

c. Duties of Reporting Funds

Chapter 3 of Part 3 sets out the general duties of an offshore fund that has applied for, and attained, reporting status. By regulation 58 those general duties are:

a. to prepare accounts in accordance with Chapter 4 of Part 3 of the Regulations, except in the case of "transparent reporting funds";

b. to provide a computation of the fund's reportable income in accordance with Chapter 5 of Part 3 of the Regulations;

c. to provide reports to participants in accordance with the requirements of Chapter 7 of Part 3 of the Regulations; and

d. to provide information to HMRC in accordance with the requirements of Chapter 9 of Part 3 of the Regulations.

The accounts of the fund must be prepared in accordance with international accounting standards or in accordance with the GAAP specified in the application for reporting status. Where a fund changes the accounting policy that it applies and that change results in a difference in the carrying value of an asset or liability of the fund then a corresponding credit or debit must be brought into account for the period after the change in policy (reg.60).

Where a fund changes its accounting policy to accord with a GAAP of some description then the fund must re-apply to HMRC for approval of the GAAP adopted. If HMRC reject the application the fund may appeal (reg.61).

d. Computation of Reportable Income of a Reporting Fund

Under regulation 63, the starting point for the computation of the reportable income of a fund for a period of account is the "total comprehensive income for the period" or the equivalent in the case of a fund that does not use international accounting standards.

If the computation gives rise to a negative amount then there is no loss: the reportable income is nil (reg.63(5)).

The "starting point" is adjusted for capital items by reference to the Investment Management Association Statement of Recognised Practice ("IMA SORP"). "Net capital gains" are to be deducted from the starting point and "net capital losses" are to be added (reg.64). Further adjustments must also be made to the starting point by adding expenses directly related to the acquisition or disposal of investments and costs relating to the setting up, merger or dissolution of the fund (reg.65).

Regulations 66 and 67 are concerned with adjustments for interest income and wholly-owned subsidiaries of the fund. In the case of the latter, wholly-owned subsidiaries are consolidated with the fund that owns them (reg.67(5)).

e. Funds of funds

Where a reporting fund ("RF1") itself holds an interest in another reporting fund ("RF2") the reported income of RF2 is taxed on RF1: this is the effect of the reg.68(2), which provides that the excess of the income reported by RF2 over the amount actually distributed by RF2 to RF1 (and therefore already included within RF1's own reportable income) must be added to RF1's reported income.

Where a reporting fund holds an interest in a non-reporting fund and has full information about the income of the non-reporting fund then the reporting fund can calculate its income taking into account the income of the non-reporting fund (reg.69 applying reg.68). If, however, the reporting fund has an interest in a non-reporting but it cannot meet the conditions in regulation 69 then no adjustments can be made in respect of capital items under regulations 64 and 65. The result of this provision is that the fair value movements of the reporting funds interest in the non-reporting fund will form part of the reported income of the reporting fund. However, if the fair value of the interest decreases, so as to create a loss, then, provided that the fund was a reporting fund when the losses occurred, they can be used to reduce gains arising on the interest in the non-reporting fund in later periods (reg.70).

Following amendments made to the Regulations with effect from 27 May 2011, the provisions just described do not apply where the reporting fund has an interest in non-reporting fund which is an "index tracking fund" (as defined) provided the conditions set out in reg.68A are met.

There are further adjustments to be made where a reporting fund operates equalisation arrangements and a participant disposes of an interest in the fund (reg.72).

f. What must be Reported - Transactions Treated as Non-Trading

Chapter 6 of Part 3 sets out the conditions that must be met before certain transactions can be treated as "non-trading" for the purposes of distinguishing income from "capital items" (under the IMA SORP) when determining what must be reported by the fund (see reg.64(3)).

There are two threshold conditions to be met before the Chapter will apply: (i) the "equivalence condition", which requires that the fund is either FSA-recognised, a UCITS fund, or a fund constituted in another EEA state meeting the conditions in reg.74(4), and (ii) the "genuine diversity of ownership" condition, which, broadly, is aimed at ensuring that participation in the fund is marketed and made available to a sufficiently wide range of investors (regs 73-76).

It is possible for fund managers to apply to HMRC for a clearance that their fund meets those two conditions (regs 77 and 79).

Under regulation 80, where the conditions just described apply to the reporting fund and it carries out an "investment transaction" (see below) in an accounting period then that investment transaction is treated as a non-trading transaction.

Regulation 81 sets out the "white list" and provides that an "investment transactions" is any transaction:

a. in stocks and shares

b. in a "relevant contract" (broadly, an option, a future or a CFD)

c. which results in the fund in question becoming party to a loan relationship or a "related transaction" in respect of a loan relationship (i.e. loan origination and debt acquisition)

d. in units in a "collective investment scheme" (as defined in s.235 FSMA 2000)

e. in securities of any other description

f. in foreign currency trading

g. in a "carbon emission trading product" (as defined in reg.89)

N.b. this is not an exclusive code for non-trading transactions and it is possible for cases outside of Chapter 6 to be non-trading transactions under general principles.

Special rules apply with effect from 27 May 2011 to determine how a transparent reporting fund must compute its reportable income (Chapter 6A).

g. Reporting to Participants

Regulation 90 states that the reporting fund must make a report available to each participant for each "reporting period" (as defined in reg.91). It also stipulates the circumstances in which a report is "made available". What is to be contained in the report itself is prescribed regulations 92 to 92D, and which regulation applies depends on the nature of the fund and on whether it operates equalisation arrangements.

h. Tax Treatment of Participants - Treatment During the Life of the Fund

The basic treatment is for the reported income of a non-transparent fund to be treated as distributed to the participants in the fund in proportion to their rights to the extent that it has not already been distributed. Where the fund is a transparent fund (see reg.11) the excess of the reported income over the income of the fund (on which the participants will be liable to tax on general principles) is treated as further income in proportion to their rights (reg.94). Adjustments can be made to that excess where the participant's rights in the fund are rights to which regulation 30 applies (see Part II of this article).

Importantly, where a fund operates "full equalisation arrangements" (see reg.50A(b)(i)) the "equalisation amount" (defined in reg.72(2)) can be deducted from the deemed distribution of the excess of the reported income (reg.94A).

In a case where the offshore fund is a body corporate (under section 355(1)(a) TIOPA 2010) participants liable to income tax are charged to tax under section 397A of ITTOIA 2005 (dividends from non-resident companies) on the distributions from the fund as well as on the excess of the reported income unless the fund is a "bond fund", in which case tax is charged to tax under section 378A of ITTOIA 2005 as if it were yearly interest (reg.95).

Similarly, if the offshore fund is not a body corporate but is non-transparent then participators liable to income tax will be charged to tax on the excess reported income under Chapter 8 of Part 5 of ITTOIA 2005 (miscellaneous income) unless the fund is a “bond fund” (reg.96).

Participants in transparent funds who are liable to income tax are taxed on the excess of the reported income under Chapter 8 of Part 5 of ITTOIA 2005 (miscellaneous income) as relevant foreign income (s.830 ITTOIA 2005) (reg.97).

For participants chargeable to corporation tax, they are taxed on distributions from the fund in the normal way, i.e. according to the character of the distributions. The excess of any reported income over such distributions is taxed in the same way under regulations 94(1) and 94(2). According to regulation 98, if the excess of the reported income would be exempt from tax if it were an actual distribution then the amount of the excess is exempt.

i. Tax Treatment of Participants - Treatment Upon Disposal of the Interest

As with the old “distributing fund” regime, the “carrot” for complying with the reporting fund rules is that upon disposal of their interest the participant is taxed within the chargeable gains regime. Moreover, to avoid double taxation, the amounts on which the participant has been charged to tax during his time participating in the fund (i.e. the excess of the reported income over the amount distributed) are aggregated and treated as amounts given for the acquisition of the interest. In other words, the base cost of participator is increased by the amount of the excess reported income (reg.99). N.b. this rule does not apply where the disposing participator is a charitable company or charitable trust (since they will not have been charged to tax on the excess reported income) (reg.101). Moreover, where regulation 94A applied, i.e. because the fund in question operates (or did operate) full equalisation arrangements, then the expenditure given for the acquisition of the interest must be reduced to take account of deductions allowed under regulation 94A.

There is a specific regulation (reg.100) in place to deal with the situation where a fund moves from reporting to non-reporting status. In those circumstances, provided that a report has been made available for the reporting fund's final period of account, a participant can elect to be deemed to have made a disposal and re-acquisition of his interest for a consideration equal to its NAV at the end of the final period of account. The election, therefore, allows the participant to "bank" his chargeable gains treatment before entering the income tax regime that applies to disposals of interests in non-reporting funds.

There are, in addition, targeted anti-avoidance provisions aimed at participators carrying on a banking business, an insurance business or a business that involves trading interests in funds (regs 102-105).

j. Further Information to be Provided to HMRC

There are further obligations on a reporting fund set out in regulation 106. In relation to each period of account the fund must provide HMRC with up to eight different pieces of information within six months of the end of the period of account in question.

Where HMRC require more information from the fund they have the power to require it by notice under regulation 107. Anyone to whom a notice is given under this regulation has a right of appeal to the Tribunal. How would HMRC enforce such a notice outside of the UK? The answer is that a failure to comply will be treated as a "serious" breach of the reporting fund requirements, with the result that HMRC will expel the non-compliant fund from the regime (see reg.113 and below).

k. Breaches of the Reporting Fund Requirements

Another new development is the provisions dealing with breaches of the various requirements imposed on reporting funds. Breaches come in two types: "minor" and "serious" (reg.108). Save where a breach is specifically designated as "serious", every breach is "minor" if there is a reasonable excuse for it or it is inadvertent and remedied as soon as possible. A breach which is not "minor" is "serious". A minor breach is not even a breach if the reporting fund corrects the breach without "HMRC intervention" (as defined).

The occurrence of a minor breach will not cause the fund to cease being treated as a reporting fund. However, where a fund accrues four minor breaches (with multiple minor breaches in the same accounting period being treated as one breach) in a ten-year period then the fourth breach is deemed a serious breach (reg.109).

i) Discrepancies between Reported and Reportable Income

A further obligation is placed on the reporting fund by regulation 110 to determine, for each "reporting period" the difference between the amount of the income reportable by the fund and the amount actually reported. The size of the difference between the reportable income and the amount reported must then be determined. The consequences under the rules can be summarised as follows:

Difference	**Action to be Taken**	**Consequence**
10% or less	None	No breach of any description: reg.110(3).
More than 10% not more than 15%	The difference must be added to the reported income in the period in which the error is "established"[1] or the following period; or the fund must make a supplementary report within three months of the end of the account in which the error is "established": reg.110(4).	If the action is taken as soon as reasonably possible, there is a minor breach: reg.110(7). If not then there is a serious breach: reg.110(8).
More than 15%	The fund must make a supplementary report within three months of the end of the account in which the error is "established": reg.110(5).	If the action is taken as soon as reasonably possible, there is a minor breach: reg.110(7). If not then there is a serious breach: reg.110(8).

ii) Incorrect/Incomplete Reports

The provision by a reporting fund of an incorrect or incomplete report to a participant or to HMRC also amounts to a breach. Where the correct report is provided as soon as reasonably possible the breach is a minor one; if not, it is a serious one (reg.111).

[1] As defined in regulation 110(9) or regulation 110(10), as appropriate.

iii) Failure to Provide Information

Where a fund fails to provide the information required under regulation 106 or fails to provide a report to each of its participators then further breaches can result unless the failure is remedied within 10 months from the end of the period of account in question. If the failure is remedied within 18 months of the end of the period of account then the breach is a minor one; if not then the breach is a serious one (reg.112).

iv) Prescribed Serious Breaches

The following are specified as serious breaches by regulation 113:

1. Having a period of account that exceeds 18 months.

2. Using an unapproved accounting standard.

3. Failing to comply with a regulation 107 information notice (unless an appeal has been made against it).

4. Failing to comply with a regulation 107 notice, as varied by the Tribunal on an appeal (unless an appeal has been made against the decision of the Tribunal).

l. What Happens if a Fund Commits a Serious Breach?

If the fund has committed a serious breach then HMRC will give notice to the fund of that fact. The effect of such a notice is to cause the fund to be treated as a non-reporting fund for the “reporting period” in which HMRC give the notice onwards (reg.114).

Where this occurs, and the fund becomes a non-reporting fund, the participators would usually be well-advised to make an election under regulation 100 so as to “bank” their capital treatment if possible.

It is open to a fund on which a regulation 114 notice is served by HMRC to appeal against its imposition (reg.115).

m. Voluntarily Leaving the Regime

A fund can choose to leave the reporting regime by giving written notice under regulation 116 to HMRC and to its participants.

Note that a fund which voluntarily left the reporting regime can apply to rejoin. A fund which was expelled cannot (reg.52).

4. Transitional Provisions

Schedule 1 to the Regulations sets out the transitional rules that apply to the new regime.

Provision	**Event Covered**	**Consequence**
Para 2	An "existing fund"[2] becomes a non-reporting fund.	Disposal of an interest in the fund is treated as a disposal of an interest in a non-reporting fund but entire period (including pre-1 Dec 2009) of ownership is taken into account.
Para 3	An existing fund (or a part of umbrella arrangements or a separate class of interest in a fund) applies to be treated as a distributing fund during the "overlap period"[3]. Paragraph 3 does not apply in respect of any period of account which ends after 31 May 2012.	If a successful application is made then the fund (or relevant part, as appropriate) may apply for distributing status in the period following the overlap period (provided HMRC have not accepted an application for reporting fund status to apply to the fund).
Para 3A	A reporting fund holds an interest in a "distributing fund"[4].	Income from the distributing fund is treated as income from a reporting fund, but with no adjustment under regulation 68.

[2] Means a fund to which s.756A ICTA applied, i.e. which was an "offshore fund".
[3] The period of account of an existing fund current on 1 December 2009.
[4] I.e. a distributing fund under the pre-1 December 2009 rules.

Provision	Event Covered	Consequence
Para 3B	A distributing fund has an interest in a reporting fund.	The reporting fund is treated as a "qualifying fund" for Part 2, Schedule 27 ICTA
Para 3C	An interest in a distributing fund is exchanged for an interest in a reporting fund.	Regulation 37 (disapplication of section 127 TCGA) does not apply.
Para 4	An existing fund is a distributing fund but does not immediately become a reporting fund in the next accounting period.	A participant may elect to be treated as disposing of an interest in the distributing fund (at NAV) at the end of its last distributing accounting period and as acquiring an interest in a non-reporting fund.
Para 5	An existing fund, which was "non-qualifying"[5] before 1 Dec 2009, becomes a reporting fund.	A participant is entitled to make a "clean slate" election under reg.48 to be treated as disposing of his interest in the existing fund at market value.
Para 6	An existing fund makes a successful application under para 3 to continue as a distributing fund and then becomes a reporting fund immediately after it ceases to be a distributing fund.	For the purpose of disposals by participators, the fund is treated as if it had been a reporting fund from the point at which it became a distributing fund.
Para 7	A fund, which was not an "offshore fund" pre-1 Dec 2009, falls to be classified as an "offshore fund" after that date.	The fund may make an application to be a reporting fund but it must be made on or before 31 May 2010.

5. Conclusions

As with any new provisions, the problems and quirks of the new rules will only really become apparent once they have been applied in practice but it seems clear that the new, and deliberately expansive, definition of "offshore fund" has the potential to create difficulties at its edges. Other features, however, such as the move away from a requirement to distribute to a reporting requirement, represent a positive step and early signs are that fund managers are interested in obtaining reporting status for their funds (or at least for certain classes of interest in them).

[5] Meaning a fund which is not a distributing fund: s.760 ICTA.

There was a period shortly after the new Regulations were enacted during which it looked like CGT rates would be increased to match income tax rates meaning that, in the absence of some sort of taper relief, the new reporting regime would potentially be rendered redundant on the basis that CGT treatment for a participant would no longer hold much attraction, especially when coupled with the heavy administrative burden that comes with reporting status. Ultimately, however, that change did not materialise and so the attractiveness of CGT treatment for UK-based investors remains. Accordingly, fund managers should continue to give careful consideration to whether the benefits to their investors of entering the reporting regime will outweigh the attendant administrative burdens.