Offshore Funds

Should you be concerned by the proposed changes?

February 2009
Executive summary

HM Treasury is currently nearing the end of its consultation process on amendments to the "offshore funds" regime in the UK, which began in 2007. Its latest paper (the "Paper") contains draft legislation which is intended to come into effect on 1 October 2009 (subject to final consultation which is open for response until 11 February).

The offshore funds rules mean that if a UK resident taxpayer invests in an offshore fund, its receipts from that fund will be treated as income, rather than capital gains (even on a disposal). For individuals, this means a potential tax bill of up to 40%, in stark contrast to the now flat 18% payable in respect of capital gains, and the rules therefore have a serious impact on the net returns available to UK resident taxpayers from such funds.

Much of the new legislation will mirror the current rules, and therefore the practical impact on many fund structures will be minimal. However, the scope of the new rules does extend further than previously, particularly in relation to close-ended vehicles (which could previously, subject to compliance with certain fairly clear parameters, be structured to be safely outside the rules).

The Paper also considers changes to the proposed "reporting fund" regime, which will provide an exception to the offshore fund rules; however, we have not focussed on that in this paper.
1 Intention and effect of the offshore fund rules

The offshore fund rules determine how receipts from funds established outside the UK are taxed in the hands of UK investors: if a UK taxpayer invests in an offshore fund, any receipts on disposal of its interest in such fund will be treated as income (and therefore, for individuals, potentially taxed at 40%), rather than capital (where gains are taxed at 18%). The regime was originally introduced as a way of preventing UK taxpayers from rolling up income in an offshore vehicle (and then just paying capital gains tax on disposal of their interest in that vehicle). However, the scope of the legislation is now wider than necessary solely to address this policy requirement.

The existing rules

The existing offshore fund rules essentially have two strands. Firstly, the fund in question must be an "offshore fund". The definition of offshore fund is based on a slightly amended version of the collective investment scheme definition used for UK regulatory purposes, and covers most collective investment arrangements established outside the UK which provide investors with the ability to realise their interests in such arrangements at a price calculated wholly or mainly by reference to the net asset value of the arrangements. Arrangements which are tax transparent for UK purposes are specifically excluded by HMRC Guidance.

Secondly, the UK investor must have a "material interest" in that offshore fund, which includes a requirement that the investor can reasonably expect to realise the investment within 7 years. The effect of the current rules is that an investment in an open-ended vehicle (e.g. open-ended investment companies and many unit trusts) will generally be caught, but an investment in a close-ended company will not be, provided that, if the close-ended company is of fixed duration, that duration is longer than 7 years. Limited partnerships, being generally treated as tax transparent for UK purposes, are excluded from the rules (although this will depend on their jurisdiction of establishment, as discussed further below).

The new rules

The purpose of the new legislation is: to simplify the operation of the offshore fund rules, and thereby provide greater certainty to UK investors and funds; to achieve, as far as possible, economic parity with the position of UK investors in UK authorised funds; and to strengthen existing anti-avoidance rules.

The most significant amendment in the new rules is the removal of the second strand of the current test; i.e., it will no longer be a requirement for the UK investor to have a "material interest" in the offshore fund in order for its profits on realisation of that fund interest to be treated as income rather than capital. The main impact of this change will be on close-ended vehicles.

Broadly speaking, the new rules will apply to arrangements or vehicles (other than those which are treated as tax transparent for UK purposes, as discussed further below) which are not UK tax resident, and in respect of which:

- the participants will not have day-to-day control of the management of the property held; and
- a "reasonable investor" would expect to be able to realise an investment based entirely or almost entirely by reference to the net asset value ("NAV") of the arrangement in question.

If the arrangement satisfies these tests, returns from it will be taxed in the hands of UK investors as income, unless it falls within an exception to this rule (as discussed below).

The requirement for the participants in the scheme to have no day-to-day control, also an element of the current rules, remains unchanged. The more interesting is the second limb, which will have increased significance under the new rules, given the removal of the "material interest" requirement.
1 Intention and effect of the offshore fund rules

Although not detailed in the draft legislation, the Paper indicates that the concept of the “reasonable investor” will be defined in guidance which follows that given in the regulatory context. This provides, amongst other things, that the reasonable investor is a hypothetical investor with sound judgement and some knowledge of the area of collective investment. The expectations that the reasonable investor is deemed to have will be based on the fund’s constitutional documents and how the rules therein are applied in practice.

The requirement that realisation will be based entirely or almost entirely on the NAV (similar to the current test, which requires realisation based wholly or mainly on the NAV – although it is not clear if there is any intended difference) will include products which provide for redemption based on the net asset value but with some adjustment for redemption fees or a bid/offer spread, but will generally exclude products whose liquidity is provided by the secondary market (e.g. listed funds other than ETFs), given that their realisation price will be based on market factors, rather than entirely or almost entirely on the NAV.

The Treasury states its intention in the Paper that close-ended companies should generally be excluded from the above definition. However, the actual exception for these companies contained in the draft legislation is a weak one. It states that arrangements which provide for realisation based on their NAV but only on the realisation or winding up of the arrangement will not be an offshore fund, which provides comfort to fund managers that they will not be caught by the offshore fund rules solely by virtue of having relatively standard winding-up arrangements. However, this exemption does not apply to arrangements with a pre-arranged life span (i.e. these will still constitute offshore funds), unless they have no income producing assets.

It is hard to think of any funds which have absolutely no income producing assets (this would generally exclude, for example, all property or private equity focussed funds and indeed any fund which may receive interest payable on cash or cash-like instruments) and therefore in practice it can be said that all close-ended funds with defined life-spans will be included. Although the Paper suggests that guidance may introduce a de minimis level of income which can be produced, it is still unlikely that a company’s directors would be willing to represent to investors at the outset that only a defined de-minimis amount of income-producing assets will ever be held by the company, and therefore an investor in such a company would always run the risk of being taxed to income on its investment. Importantly, such funds can no longer rely on the fact that a life span of longer than 7 years will keep them outside the offshore fund rules.

Additional exceptions are referred to in the Paper, although not set out in the new legislation itself (it is anticipated that these will continue to be dealt with by way of HMRC Guidance). The first of these, which reflects existing law and practice, relates to offshore vehicles which are treated as transparent for UK tax purposes, which will not be caught by the rules. However, care has always needed to be taken in this regard, and this will not change. The key to the statement is the recognition of tax transparency for UK tax purposes. Just because a fund is deemed to be tax transparent in the jurisdiction in which it is resident, does not necessarily mean that it will be recognised as such by HMRC. For example, although HMRC generally recognises non-UK limited partnerships as transparent, the situation is less certain when it comes to non-UK limited liability partnerships, which, although often tax transparent in their home jurisdiction, are generally not seen as tax transparent by HMRC.

It is also important to recognise that investing into a tax transparent offshore entity may not be the end of the analysis. If that entity is treated as transparent, a UK resident investor will be deemed to hold its underlying investments directly. It is possible that one or more of these investments may themselves be offshore funds, and the investor will therefore be treated as holding an interest in such funds.
1 Intention and effect of the offshore fund rules

The Paper also refers to an exception for capital only arrangements, but this is not actually reflected in the legislation (other than in the context of limited life funds with no income-producing assets), and we will have to wait to see whether any HMRC guidance will be introduced on this point.
The change in the law regarding close-ended investment vehicles will undoubtedly affect fund structuring in certain circumstances. However, the impact on most "standard" fund structures of the new rules will be more limited.

Hedge funds:
Offshore hedge funds which offer liquidity through redemptions will continue to be caught by the offshore fund rules.

Private equity funds:
The majority of private equity funds, which are structured using limited partnership vehicles which are transparent for UK tax purposes, will continue to be outside the offshore fund rules (unless they are established using a more unusual vehicle or in a jurisdiction that is not recognised as tax transparent by HMRC). Offshore unit trust feeder vehicles will generally continue to be offshore funds (and for this reason will still generally only be attractive to non-UK investors and/or UK tax-exempt investors such as registered pension funds and individuals investing through a SIPP).

Open-ended investment companies/unit trusts:
These vehicles will continue to be caught by the offshore fund rules.

Permanent capital/listed funds:
Permanent capital funds which provide liquidity through the secondary market will continue to remain outside the offshore fund rules (unless they also have a defined lifespan after which proceeds are returned to investors based on the NAV).

Close-ended funds with a buy-back mechanism or fixed-life:
The new rules will be of concern for anyone structuring a fund like this.

Action?
If fund managers, or advisers to UK taxpayers, anticipate that the new rules will have an impact on their businesses or clients, they may consider lobbying the Treasury for further clarification of the rules (either in the legislation itself or via HMRC Guidance).

There is also comfort in the fact that any investment made prior to the introduction of the new definition (currently set for 1 October 2009) into a fund that is not an "offshore fund" will retain that treatment even if the fund in question would fall within the revised definition. The changes will therefore only impact investments made after the agreed commencement date.

These materials are provided for general purposes only. Osborne Clarke does not accept liability for the contents of these materials and legal advice should be taken in respect of a particular matter.

We are not responsible for the content of any external websites.
Helen is a Senior Associate in Osborne Clarke’s Financial Institutions Group. Helen has a broad range of experience in relation to the asset management sector. She specialises in providing advice to asset managers in relation to the establishment of investment funds, and has advised on funds taking various forms (including limited partnerships, open- and closed-ended investment companies and various feeder structures) and with various investment focuses (including private equity, real estate, debt, and hedge funds).

Helen also advises fund of funds and other institutional investors on their fund investments, and provides other advice on legal and regulatory issues affecting the asset management sector generally.

Helen trained at Clifford Chance, where she qualified in 2003. She worked in Clifford Chance’s financial institutions group for two years before moving to Allen & Overy. Helen joined Osborne Clarke in February 2008.

t 0117 917 3432
t 0117 917 3433
helen.parsonage@osborneclarke.com

Erika is a partner in the corporate tax unit and has wide experience of advising both UK and multinational groups on a broad range of corporate tax issues. She advises on all aspects of corporate tax issues including value added tax, stamp duties and SDRT, employee and cross-border tax issues, with a particular emphasis on mergers and acquisitions, joint ventures, corporate finance, flotations and banking and asset finance transactions. She has advised clients in a broad range of sectors including manufacturing, venture capital, transport and IT and telecoms.

Erika qualified as a solicitor in 1990 and worked in the corporate tax department of Slaughter and May for 6½ years before joining Osborne Clarke in 1997. She became a partner in 1998.

t 0117 917 4260
t 0117 917 4261
erika.jupe@osborneclarke.com