

The UK's Revised Offshore Fund Tax Regime

By Robert Kent

Robert Kent explains the new United Kingdom tax policy regarding investment in offshore funds.

With effect from December 1, 2009, the United Kingdom ("UK") has introduced legislation¹ replacing its previous "offshore fund" tax regime² with a new, more challenging version. The new regime is designed to achieve the same broad policy objective, but differs significantly both in scope and in approach when compared with the previous regime.

This article will explain the policy and legislative background to the regime, briefly outline the history of the previous regime, explain the main features of the regime and highlight the practical implications and important areas of commercial uncertainty surrounding its scope.

To clear up one possible point of confusion immediately, the regime is not about the taxation of offshore funds themselves. Indeed, such funds are of course generally outside the territorial reach of UK taxation, other than in respect of any UK source income. Rather, it is a regime for taxing UK investors in such funds.

Context of the Wider UK Tax System

In UK tax case law, the concept of "income" has never included capital gains. In this article I use the expression "ordinary income" in accordance with U.S. parlance to denote profits which are of a revenue rather than capital nature, but the expression is not generally used by the UK legislature, nor is it generally used by UK tax practitioners.

Ever since the introduction of income tax in the UK, capital gains have been treated more favourably than

ordinary income. Prior to the introduction of capital gains tax (CGT) in 1965 (and the introduction that same year of corporation tax, which applies to both ordinary income and capital gains realised by companies with UK resident status or a UK permanent establishment), such gains went completely untaxed, due to the UK interpretation of the word "income" referred to above. Even after 1965, the CGT regime has always been more lenient than the income tax regime, albeit in different ways at different stages of recent history. For example, a UK resident individual is entitled to an "annual exempt amount" for CGT purposes in addition to, and substantially greater than, his income tax personal allowance (*i.e.*, tax-free band). Furthermore, capital gains realised in a tax year in excess of that band are currently subject to a flat rate of 18 percent, in contrast to marginal income tax rates of up to 50 percent for the UK tax year commencing April 6, 2010.

Position Before Offshore Funds Regime Introduced

Unsurprisingly therefore, UK taxpayers have long commonly sought to realise capital gains in lieu of ordinary income where possible. Historically, one obvious means of doing so was to invest in a non-UK resident investment company that would itself realise income outside the territorial scope of UK taxation, and would refrain from distributing that income as dividends. Then the arrangements would enable the investor to realise the economic benefit of such income in capital form, for example on a redemption or purchase of the investor's shares, or by way of a liquidation distribution. Since the late 1930s, the UK has had a special set of anti-avoidance rules known, slightly misleadingly, as the "transfer of assets abroad"

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legislation,³ which has countered such planning very successfully in cases where special arrangements are made for families or other small groups of investors. Indeed that regime remains potentially relevant to the marketing of offshore funds to UK investors. The government was not confident, though, that the “transfer of assets abroad” legislation would catch “retail” funds that were mass-marketed to large numbers of investors who had not been involved in designing such funds. Therefore, in 1984, the UK “offshore funds” tax regime was enacted to counter the UK tax benefits which would otherwise arise from the offshore roll-up of income. In this article I will refer to the regime that existed, amended from time to time, from 1984 until the end of November 2009 as the “old offshore funds regime.”

The Old Offshore Funds Regime

General Points

The essence of the old offshore funds regime was to treat certain gains realized upon a disposition⁴ of an interest in an offshore fund as ordinary income rather than capital gain. If an investor had a “material interest” in an “offshore fund” (terms which are discussed below), and the fund was not certified by HMRC⁵ as a “distributing fund,” then any gain realised by the investor on the disposal of his interest would be treated for UK tax purposes as ordinary income (with the label of “offshore income gain”) instead of as capital gain. The rules applied both to individual and to corporate investors, though the consequences of such treatment differed between the two categories as a result of differences between the UK tax regime applicable to those two categories more generally.

Note that the regime merely recharacterised capital gains as ordinary income as and when realised. It did not counter deferral benefits, nor, in the case of individuals, did it generally capture gains which were deferred until after emigration from the UK, since the UK has no general exit tax charge for emigrating individuals.⁶

Note also, however, that the rules can have very severe consequences. In particular, the amount taxed as ordinary income on the disposal by the investor is not in any way limited to amounts which represent rolled up ordinary income, but covers the entirety of the investor's gain, even if all of it represents underlying capital gains, due for example to increases in the share price of listed companies in which the offshore fund has invested. The rules thus work particularly unfairly in relation to equity funds.

Old Definition of “Offshore Fund”

The concept of “offshore fund” was broadly defined, so as to include (1) companies (the term used most commonly in the UK to refer to corporations) resident outside the UK, (2) unit trust schemes with non-UK resident trustees, and (3) co-ownership arrangements taking effect under non-UK law.

An important restriction on the scope of the concept was however introduced in 1995 when it was limited to collective investment schemes (CISs) within the meaning of that expression under UK regulatory law. That made it necessary for UK tax advisers in the investment fund sector to familiarise themselves with the intricacies of the regulatory legislation in order to determine, for UK tax purposes, whether a non-UK entity or arrangement fell within the regulatory definition of a CIS. The restriction to CISs had a number of implications, but by far the most important consequence was the exclusion of the vast majority of closed ended corporate vehicles. That is because UK regulatory law provides that a “body corporate” cannot be a CIS unless it is an open-ended investment company (OEIC). The statutory definition of an OEIC is complex, but one key element is that a company will not be an OEIC unless a “reasonable investor” would, if he were to invest in the company, “expect that he would be able to realize, within a period appearing to him to be reasonable, his investment ...” and would “be satisfied that his investment would be realized on a basis calculated wholly or mainly by reference to the value of [the company's assets].” A typical closed-ended investment company, marketed to investors on the basis of a listing and a liquid secondary market, would fail that condition because the investor's prospect of realising his investment would depend on price fluctuations driven by supply and demand in the secondary market for the company's shares, which could cause substantial divergence between the company's market capitalisation and its net asset value (NAV). Investors in such companies were not therefore generally caught by the old offshore funds regime.

“Material Interest” Concept: Seven-Year Test

The expression “material interest” was something of a misnomer, as it had nothing to do with the size or significance of the investor's holding. Rather, it meant an interest in an offshore fund that the investor could reasonably expect, at the time the investor acquired it, to be able to realise at NAV within a period of seven

years. So, for example, if a closed-ended investment vehicle had a prescribed limited life of 10 years, then an investor who invested in the first three years would not normally have such an interest, but an investor who invested from the fourth year onwards generally would have such an interest.

During the years prior to 2007, HMRC started to perceive a loophole in the rules. In HMRC's view, arrangements which contemplated realisation on an NAV basis within seven years were intended to be caught by the regime, reflecting the seven-year test in the definition of "material interest." However, offshore investment companies with a fixed life of less than seven years were being marketed to UK investors on the basis

that the regime would not apply, on the grounds that the life of the vehicle, say three years for example, was not a "reasonable period" within the definition of an OEIC as outlined above, so that the company was not an OEIC, thus not a CIS, thus not an "offshore fund" for the purposes of the tax rules. The UK government therefore changed the law⁷ in 2007 by providing that, for the purposes of the tax definition of "offshore fund," the question whether a company was a CIS would be determined without any regard to the "reasonable period" concept in the definition of an OEIC which otherwise applied. The detailed wording of the 2007 change to the statute created some difficult points of uncertainty, which were addressed in a rather unsatisfactory manner by some published HMRC guidance in Q&A form.⁸ However, the benefit of a clear seven-year test for the "material interest" definition⁹ remained, until the more radical reforms now effected by the new Offshore Funds regime.

Distributing Fund Exemption

As the entire purpose of the regime was to combat the roll-up of ordinary income and its realisation by investors in capital form, there was an exclusion for investors in so-called "distributing funds." Offshore funds with a substantial UK investor base would therefore often take steps to ensure that they acquired and preserved such status. The requirements¹⁰ were onerous. Such status applied only if certified, certification was done on an accounting period by accounting period basis (such periods typically being annual), and the investor would obtain the benefit of

exclusion (*i.e.*, the benefit of capital treatment for his gain on the disposal of his investment) only if the fund had been certified by HMRC as a distributing fund in respect of every single accounting period of the fund during which the investor had held his interest.

In order to be certified as a distributing fund in respect of an accounting period, a fund was required to distribute at least 85 percent of its income as determined in its accounts or, if greater, an amount equal to at least 85

percent of its ordinary income profit as determined under UK corporation tax principles on the basis of the fiction that the fund was a UK resident company. It also had to comply with certain investment restrictions which placed limits on investment in other offshore

funds (and were often problematic for investors in funds of funds) in order to prevent the regime being circumvented by the roll-up of income in a lower-tier entity.

Transparent and Partly Transparent Entities

Funds of a type which were transparent for the purposes of UK income taxation, such as most offshore unit trusts, had the benefit of a rule¹¹ which deemed income to be distributed (so as to satisfy the distribution requirement) to the extent that it was taxed on a look-through basis. Such funds still needed to go through the certification process each year though, so that HMRC could monitor their compliance with the investment restrictions, and failure to certify resulted in the operation of the "offshore income gain" charge for investors on realisation of their interests.

Partnerships were generally outside the regime altogether *per se*, on HMRC's view of the law, as they are generally transparent for UK tax purposes in respect of ordinary income and (unlike offshore unit trusts) in respect of capital gains,¹² so that an investor could be subject to an offshore income gain charge on the occasion of realisation if he was a partner in a partnership which itself invested in a nondistributing offshore fund.

The New Offshore Fund Regime: the Main Changes

The new offshore fund regime differs from the old regime in three main ways (as well as in scores of lesser ways of course):

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- There is a completely new definition of “offshore fund,”¹³ which is no longer based on the incorporation by reference of definitions and concepts from UK regulatory legislation, but borrows language from such definitions on a selective basis.
- There is no “material interest” (*i.e.*, seven-year) test, nor indeed any kind of restriction on the scope of the regime by reference to the duration for which an investor must hold his interest before being able to realize it on an NAV basis.
- The “distributing fund” exclusion has been replaced by a “reporting fund” exclusion,¹⁴ under which a fund may elect for its ordinary income profits to be taxed to investors on a look-through basis without any actual distribution occurring (with a corresponding addition to the investor’s basis for CGT purposes where income is taxed in his hands without being distributed to him).¹⁵

The first two of those changes are bad news for investors and fund promoters, whilst the third is a welcome measure allowing increased flexibility.

The New Definition of “Offshore Fund”

The key expression “offshore fund” is now defined in the following terms (by reference to the term “mutual fund,” itself new to UK tax legislation, discussed below):

- (a) a mutual fund constituted by a body corporate resident outside the United Kingdom,
- (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
- (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.

It will be seen that, so far, the definition is essentially along the same lines as the old definition, but with the new term “mutual fund” in place of the old CIS concept. So the nub of the controversy is in the definition of that new term, which is drafted in the following terms (largely derived from the language of UK regulatory statute, but subtly changed):

- (1) “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 –

- (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 purpose 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 –
 - (a) the net asset value of the property that is the subject of the arrangements, or
 - (b) an index of any description.

Sections 360 and 361 referred to above merely clarify the operation of the definition in the case of umbrella funds with sub-funds, and in cases where there are different classes of interests in funds. Sections 357 and 359 contain exclusions for special cases, including so called constant NAV funds, and (subject to important further conditions which adversely affect limited life funds) funds under which an investor can expect to realise his investment at NAV only on a liquidation, termination or winding up of the relevant arrangements.

Scope of the New Regime: Risks for Closed-Ended Investment Vehicles

The offshore fund regime in the UK has always applied to investments in open-ended vehicles, such as open-ended investment companies and unit trust arrangements, under which investors have the opportunity at regular intervals to redeem their investment at a price fixed by reference to a frequently measured NAV. That is noncontroversial.

The most contentious aspects of the new regime have involved the extent to which it catches, or may catch, investors in closed-ended investment vehicles. There is a large market in the UK (in relation to a wide variety of underlying asset classes) for listed closed-ended investment companies, often incorporated and resident in Jersey or Guernsey, or in other low-tax jurisdictions depending on the location of underlying assets. Promoters of such vehicles used to find it easy to conclude that the UK's offshore fund rules had no application to their investors. That is no longer the case.

The question is most difficult in relation to limited life companies. Clearly, when a company is liquidated, its assets are generally sold and the proceeds distributed to shareholders after satisfaction of creditors, which amounts in terms of the UK's tax regime to the realisation by investors of their investment on an NAV basis. The absence of any limit on the time period involved now means that, if a company has a fixed date for winding up, set for example by its governing documents, then even if that date is 100 years away, the regime still applies to the UK investors just as if the company were an OEIC which offered daily redemptions on an NAV-linked pricing basis. The rules generally disregard the possibility of NAV realisation on a winding up, but that disregard does not apply if the "arrangements" (in this case the company) are "designed to wind up on a date stated in or determinable under the arrangements."

Problems arise also in relation to discount control measures which are commonly implemented by closed-ended investment companies in order to mitigate the discount to NAV at which their shares are traded, such as share repurchase programs.

HMRC has published extensive guidance¹⁶ on the new legislation. Given the uncertainty created by the language of the statute itself, it will be necessary for promoters and investors to rely on the terms of the HMRC guidance in a wide variety of scenarios. The guidance covers most of the common problems likely to arise, such as share buyback programs, other discount control measures, and limited life companies. Unfortunately, the guidance is not free of contradictions. One shortcoming is that it contains ostensibly comforting passage in very broad and woolly terms which are not borne out by the specific comments on specific questions. For example, the guidance states "*It is expected that relatively few fixed share capital companies will fall within the new definition. But ... entities that have fixed share capital and that are structured in such a way that they share characteristics of open-ended share*

capital arrangements (that is, the share capital expands and contracts in response to demand) will be within the definition." That sounds comforting to an advisor considering the case of a closed-ended vehicle with no provision for share buy-backs and whose share price is expected to be entirely driven by the secondary market for decades to come. But if the company has a provision in its governing documents for a winding up vote on a fixed date, be it 50 years away, there is a technical problem. The adviser then has to analyse what an investor's expectation would be with regard to the result of such winding-up vote.

The various official consultation papers which preceded and accompanied these reforms set out five key policy criteria, being (1) simplicity, (2) parity of treatment between investment in UK and in offshore funds, (3) certainty, (4) effective prevention of avoidance, and (5) revenue neutrality for the exchequer. It must be said that by reference to the criterion (3) the reforms have done very poorly, principally due to the abolition of the "material interest" seven-year test. In comments which are nothing short of Orwellian, the official documents claim that the abolition of the test increases certainty.

A particular concern has arisen in relation to normal, closed-ended corporate vehicles with unlimited life which are themselves owned by limited life funds. For example, a private equity fund established as a partnership with a long-stop date for realization of its investments and distribution of proceeds to the limited partner investors will commonly set up a chain of SPV entities for the purpose of corporate acquisitions, often using Luxembourg holding companies (LuxCo) for the purpose of acquisitions around Europe. The concept of "arrangements" is defined very widely, so there is a technical concern that the arrangements at the partnership level could result in a LuxCo owned by the partnership being brought within the definition of "offshore fund" (with adverse implications for taxable UK limited partners) even though there is nothing about the company itself which sets any time horizon for a winding up. HMRC have given informal indications that public guidance will be forthcoming which should give comfort to the private equity sector on this point, but at the time of writing it is still awaited.

Holdings in Nonreporting Funds

UK investors in nonreporting offshore funds will have their gains on disposal of their interests treated as ordinary income under the "offshore income gain" category.

There are exclusions for cases where the gain is in any event taxed as ordinary income under other rules of UK tax law, such as where the UK taxpayer holds an interest in the fund as “trading stock” (inventory in U.S. parlance), or where a UK company holds an interest in a bond fund (*i.e.*, a mainly debt invested fund), in which case the company is in any event required under other UK tax legislation¹⁷ to mark its holding to market and to treat fluctuations in value as income or expense.

Reporting Funds: Duties

Where a fund is a reporting fund, a UK investor will generally benefit from capital gain treatment of the gain he realizes on disposal of his investment, in recognition of the fact that he has been taxed on the income arising in the fund on a year by year basis.

If an offshore fund wishes to have “reporting fund” status it needs to apply to HMRC for such status. If such status is granted, the fund will have duties under the Offshore Fund (Tax) Regulations 2009 (the “Regulations”) under the following headings:

- (a) To prepare accounts in accordance with the provisions of the Regulations
- (b) To provide a computation of its “reportable income” in accordance with the Regulations
- (c) To provide reports to participants in accordance with the Regulations
- (d) To provide information to HMRC in accordance with the Regulations

The accounts must be prepared in accordance either with international accounting standards, or in accordance with a national version of GAAP specified in the fund’s application for reporting fund status and acceptable to HMRC. HMRC will want to ensure that the GAAP used includes proper recognition of income, including a method of recognising finance income that properly recognizes accruing discount, for example like the “effective interest method” in IAS 39.

Trading Funds

A reporting fund will have to determine whether gains and losses arising from dispositions of its investments will be taken into account in determining its ordinary profits or will be excluded as capital gain or loss. UK tax problems arise in a variety of contexts with regard to the long-standing UK distinction between “trading” and investment activity. Where transactions are viewed as “trading” on the basis of UK tax case law (which looks to the overall mix of factors such

as the frequency of turnover of a portfolio, level of income yield on a putative “investment,” level of debt financing and so on) rather than as the turnover of a portfolio of investments held as capital assets, then the profit will be trading income rather than capital gain. Although there is a general assumption that an investment fund will not be “trading,” it is very difficult to rule it out where the business model or strategy of a fund involves short selling or other indicia of trading. In the context of diversely held UK authorised funds, there is now a statutory white list of asset classes (covering most common asset classes other than physical commodities, real estate and certain derivatives of real estate), dealings in which are automatically deemed not to be trading when carried out by such funds. The benefit of that white list, in determining the income of offshore funds for reporting purposes, is available only to investors in a very limited category of offshore fund, namely funds which both (1) satisfy certain tests related to genuine diversity of ownership, and (2) a regulatory status¹⁸ under UK regulatory law regarding the recognition of funds that the UK views as broadly equivalent to UK authorized funds. Moreover, the benefit of the white list in such cases is purely in relation to the position of the investors, and is not available in relation to the fund itself should it carry out such transactions through a potential permanent establishment in the UK. Any UK investment managers acting for such funds will therefore continue to need to be sure that they meet the requirements of the UK investment manager exemption¹⁹ (the UK domestic tax law proxy in the investment management context for the OECD model treaty concept of an independent agent acting in the ordinary course of business).

Rollover Provisions

In order to prevent avoidance of the offshore income gain charge by using UK capital gains rollover reliefs which normally apply on share-for-share exchanges and similar transactions, those reliefs are disapplied where shares in a nonreporting offshore fund are exchanged for shares in another entity.

Grandfathering

There is an exemption²⁰ from the new regime for investments acquired by UK investors prior to December 1, 2009 (or pursuant to certain legally binding agreements entered into before April 30,

2009) which were not “material interests” in an “offshore fund” under the old offshore funds regime.

Transitional Provisions

There are numerous permutations which can be conceived relating to whether a fund was or was not a “distributing fund” under the old offshore fund regime and is or is not a “reporting fund” under the new regime. In addition, under the new regime, a fund may

change status from reporting to nonreporting or *vice versa*. In general, the various provisions of the Regulations achieve a sensible transitional result in such scenarios, usually by means of an elective deemed disposal regime which allows capital gains treatment for growth in value accruing during a period of distributing or reporting status and imposes an offshore income gain charge on the realization of such part of the growth in value as is attributable to the nondistributing or, as the case may be, nonreporting period.

ENDNOTES

- ¹ The new primary legislation (which is brief, consisting of not much more than the provisions which together define the revised concept of an “offshore fund”) was introduced in Schedule 22 to the Finance Act 2009, originally in the form of amendments to the Finance Act 2008, but it has now been consolidated as Part 8 of the Taxation (International and Other Provisions) Act 2010. The secondary legislation, which is much longer and contains the substantive taxing provisions, is in the Offshore Funds (Tax) Regulations 2009 (SI 2009/3001).
- ² The legislation for the old regime (parts of which remain applicable in some circumstances under transitional rules) is at Chapter 5 of Part 17 of the Income and Corporation Taxes Act 1988.
- ³ Now rewritten as Chapter 2 of Part 13 of the Income Tax Act 2007.
- ⁴ The U.S. term “disposition” is used in this article, but the corresponding UK statutory term used by the UK tax community would be “disposal.”
- ⁵ Her Majesty’s Revenue and Customs is the UK’s national tax authority, created by the merger in 2005 of the Inland Revenue (its predecessor in relation to direct taxes) and Her Majesty’s Customs & Excise (its predecessor in relation to indirect taxes).
- ⁶ In contrast to the charge to tax on unrealised capital gains of emigrating companies under section 185 Taxation of Chargeable Gains Act 1992.
- ⁷ By way of amendments to section 756A(3) of the Income and Corporation Taxes Act 1988.
- ⁸ That Q&A guidance is to be found at Appendix 3 (“OSFGAPP3”) of HMRC’s publicly available official manual on the old offshore funds regime, which at the time of writing remains online at www.hmrc.gov.uk/manuals/osfgmanual/index.htm.
- ⁹ At section 759(2) Income and Corporation Taxes Act 1988.
- ¹⁰ Set out at section 760 and Schedule 27 Income and Corporation Taxes Act 1988.
- ¹¹ Paragraph 3 of Schedule 27 Income and Corporation Taxes Act 1988.
- ¹² The UK tax treatment of partnership capital gains is governed by the very brief section 59 Taxation of Chargeable Gains Act 1992 and the considerably longer and more detailed HMRC Statement of Practice D12.
- ¹³ Section 355 Taxation (International and Other Provisions) Act 2010.
- ¹⁴ Part 3 of the Offshore Funds (Tax) Regulations 2009.
- ¹⁵ Capital gains realized within a reporting fund are not taxed through to investors. Rather an investor may realize a capital gain on termination of the investment in the fund.
- ¹⁶ The guidance is currently at www.hmrc.gov.uk/offshorefunds/offshore-funds-manual.pdf but will shortly be available in the “Manuals” area of the HMRC Web site.
- ¹⁷ Section 490 Corporation Tax Act 2009.
- ¹⁸ The regulatory status requirement is that the fund must be registered in the UK (for the purpose of enabling shares in such funds to be lawfully marketed to prospective UK investors) with the Financial Services Authority (the relevant UK regulatory authority) under certain specific provisions of the Financial Services and Markets Act 2000.
- ¹⁹ Section 1146 Corporation Tax Act 2010.
- ²⁰ Regulation 30 of the Offshore Funds (Tax) Regulations 2009.

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