

EXPLANATORY MEMORANDUM TO
THE OFFSHORE FUNDS (TAX) REGULATIONS 2009

2009 No. 3001

1. This explanatory memorandum has been prepared by the Commissioners for HM Revenue and Customs, on behalf of HM Treasury, and is laid before the House of Commons by Command of Her Majesty.

This memorandum contains information for the Select Committee on Statutory Instruments.

2. **Purpose of the instrument**

- 2.1 These Regulations make new provision for the taxation of UK resident investors in offshore funds.

3. **Matters of special interest to the Select Committee on Statutory Instruments**

- 3.1 These Regulations are the first regulations to exercise the powers conferred by section 41(1) of the Finance Act 2008; and, in accordance with section 42A(2)(c) of that Act, have been laid in draft before the House of Commons for approval by resolution of that House. (Section 42A of the Finance Act 2008 was inserted by paragraph 5 of Schedule 22 to the Finance Act 2009.)

4. **Legislative Context**

- 4.1 The current legislation relating to the taxation of investors in offshore funds is contained in Chapter 5 of Part 17 of the Income and Corporation Taxes Act 1988 (consisting of sections 756A to 763 of that Act).
- 4.2 It is wished to make new provision for the taxation of those investors (see Part 7 of this Memorandum). Legislation providing for the making of regulations on this matter was accordingly introduced in sections 41 and 42 of the Finance Act 2008. Following the enactment of further legislation (to be found in Schedule 22 to the Finance Act 2009), the relevant primary legislation now consists of sections 40A to 42A of the Finance Act 2008. That legislation provides for the definition of the expression “offshore fund” and for the making of regulations.

5. **Territorial Extent and Application**

- 5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Financial Services Secretary to the Treasury (Lord Myners) has made the following statement regarding Human Rights:

“In my view the provisions of the Offshore Funds (Tax) Regulations 2009 are compatible with the Convention rights.”

7. Policy background

- 7.1 The purpose of these Regulations is to modernise the rules for the taxation of investors in offshore funds in line with the new definition in Finance Act 2009 so that, as far as possible, United Kingdom investors make their investment decisions for commercial reasons and not to obtain unintended tax advantages.
- 7.2 The Regulations originate from an announcement made by the Government in the 2007 Pre Budget Report proposing changes to the offshore funds regime. A principal objective of the proposals was to remove UK tax barriers to multi-tiered fund structures. In addition, the Government stated that it intended to legislate for a modernised offshore funds tax regime.
- 7.3 The Regulations will define certain offshore funds, as ‘reporting funds’. UK resident investors in these funds will be taxable on their share of the fund’s reported income each year. Any gain or loss on disposal will be treated as a capital gain or loss.
- 7.4 In particular it is intended to provide a facility for offshore reporting funds to enable UK investors to accumulate their taxed income in the fund, thus providing economic parity with the ownership of accumulation units in UK authorised investment funds.
- 7.5 The Regulations maintain the existing principle of treating untaxed accumulated income and gains in non-reporting offshore funds as offshore income on realisation. This is an anti-avoidance measure designed to reduce any incentive to accumulate untaxed income offshore on which an investor would, without these provisions, be subject only to tax on chargeable gains on disposal.
- 7.6 The regulations will replace, and therefore will repeal, the existing legislation relating to the taxation of UK investors in offshore funds.

8. Consultation outcome

- 8.1 The policy underlying these Regulations and drafts of these Regulations has been the subject of extensive formal public consultation. The consultation originated with “*Offshore funds: a discussion paper*” published in October

2007 followed by “Offshore funds: next steps” in March 2008”. Further consultation was carried out after the publication of “*Offshore funds: further steps*” containing draft Regulations and proposals for a new definition of an offshore fund in December 2008. As a result of the formal consultations, a number of changes have been made to the draft Regulations.

8.2 The Government intends to keep the regulations under review in the light of industry’s initial experiences of operating the new tax regime for offshore funds.

9. Guidance

9.1 Guidance on the definition of an offshore fund and on these Regulations will be published in a new HMRC Offshore Funds Manual.

10. Impact

10.1 The impact on fund businesses is to provide small positive administrative savings. The impact on business, charity or voluntary body investors is to widen potential investment options.

10.2 The impact on the public sector is negligible.

10.3 An Impact Assessment is attached to this memorandum.

11. Regulating small business

11.1 There was a wide ranging consultation on this measure and it is anticipated that the benefits and savings will be available proportionately to smaller firms.

12. Monitoring & review

12.1 The Government intends to monitor the effects of these Regulations on industry.

13. Contact

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Summary: Intervention & Options

Department / Agency:
HMT

Title:
Impact Assessment of Offshore Funds: a modernised regime.

Stage: Implementation Version: V3 Date: 8 October 2009

Related Publications: Related publications and consultations can be found at:
http://www.hm-treasury.gov.uk/pbr_csr07_offshore.htm

Available to view or download at:

<http://www.hmrc.gov.uk/ria/index.htm#full>

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What is the problem under consideration? Why is government intervention necessary?

The main purpose of the offshore funds regime is to establish the tax treatment of activities, which seek to use certain offshore funds to convert income flows into capital gains.

The marketplace for funds has changed significantly since these rules were introduced in 1984. As a result of commercial and regulatory developments, the Government announced in October 2006 that it would consult to ensure that tax regime does not act as a barrier to the commercial development of multi-tiered funds.

What are the policy objectives and the intended effects?

- to remove UK barriers to multi-tiered fund structures;
- to simplify the operation of the offshore funds tax regime;
- to achieve, to the extent possible, economic parity with the position of UK investors in UK authorised funds, whilst recognising that the Government has no taxing rights over non-UK vehicles themselves;
- to strengthen existing anti-avoidance rules so that UK investors who chose to invest into offshore funds do so based on commercial decisions and not to obtain unintended tax advantages;
- to implement a modernised regime at no increase in cost to the UK exchequer.

What policy options have been considered? Please justify any preferred option.

1. Do nothing - this would mean the tax rules continue to impede the development of multi-tiered fund structures that are permissible under regulatory rules.
2. Modernise the offshore funds tax regime - this would remove the restrictions that impede the development of multi-tiered funds, as well as increasing simplicity and certainty for funds and UK investors.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The impact of the measure will be reviewed within 3 years of implementation.

Ministerial Sign-off For final proposal/implementation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister:



Date: 13. 10. 09

Summary: Analysis & Evidence

Policy Option:

Description:

COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups' The Government envisages that the managers of funds opting to become Reporting Funds under the proposed reform will incur a small one-off cost in familiarising themselves with the new tax rules. HMRC will also incur a one-off cost in amending its systems. Further details of these can be found in the Evidence Base (below).
	One-off (Transition)	Yrs	
	£ Small		
	Average Annual Cost (excluding one-off)		
	£ neg		Total Cost (PV) £ Small
Other key non-monetised costs by 'main affected groups'			
From the point of view of the Exchequer, the measure is forecast to be broadly revenue neutral			

BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups' Monetising the benefits arising from the modernised regime such as increased certainty and administrative easement are extremely difficult due to the current volatility in the market. Accordingly, the benefits have been laid out in qualitative form, as explained further in the Evidence Base.
	One-off	Yrs	
	£ Unquantified		
	Average Annual Benefit (excluding one-off)		
	£ Unquantified		Total Benefit (PV) £ Unquantified
Other key non-monetised benefits by 'main affected groups'			

Key Assumptions/Sensitivities/Risks The new regime aims to deliver substantial simplification to the reporting requirements of offshore funds. Overall the Government believes that these ongoing benefits will outweigh the one-off costs incurred to become familiar with the regime.

Price Base Year	Time Period Years	Net Benefit Range (NPV) £	NET BENEFIT (NPV Best estimate) £ Positive			
What is the geographic coverage of the policy/option?			UK / International			
On what date will the policy be implemented?			01 December 09			
Which organisation(s) will enforce the policy?			HMRC			
What is the total annual cost of enforcement for these organisations?			£ neg			
Does enforcement comply with Hampton principles?			Yes			
Will implementation go beyond minimum EU requirements?			N/A			
What is the value of the proposed offsetting measure per year?			£ n / a			
What is the value of changes in greenhouse gas emissions?			£ n / a			
Will the proposal have a significant impact on competition?			No			
Annual cost (£-£) per organisation (excluding one-off)			Micro	Small	Medium	Large
Are any of these organisations exempt?			No	No	N/A	N/A
Impact on Admin Burdens Baseline (2005 Prices)			(Increase - Decrease)			
Increase of	£	Decrease of	£	neg	Net Impact	£ neg decrease

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Background

The UK tax regime for offshore funds was introduced in 1984. Broadly, its purpose was to establish the tax treatment of activities that seek to use certain offshore funds to convert income flows into capital gains. Prior to its introduction, a UK investor could accumulate income in an offshore fund, and, when the investment was realised, be subject only to tax on capital gains rather than having to pay tax on income. In contrast a combination of regulatory and tax rules meant that UK investors had to pay tax annually on income from UK funds.

The marketplace for funds has changed significantly since these rules were introduced. For example, in 1984 it was not possible to market unit trusts and open-ended investment companies from one European Union (EU) country to another. However, developments in the EU regulatory environment have opened up the market to cross-border selling, encouraging the development of pan-European retail products, for example UCITS funds. Further commercial and EU market developments have also produced an expansion in investment opportunities, including the increasing use of multi-tiered fund structures.

One of the Government's main objectives in making changes to the offshore funds tax regime is to remove UK tax barriers to multi-tiered fund structures. At the same time the Government aims to:

- simplify the operation of the offshore funds tax regime;
- provide more certainty to UK investors and funds;
- achieve, to the extent possible, economic parity with the position of UK investors in UK authorised funds, whilst recognising that the Government has no taxing rights over non-UK vehicles themselves;
- strengthen existing anti-avoidance rules so that UK investors who choose to invest into offshore funds do so based on commercial decisions and not to obtain unintended tax advantages; and
- implement a modernised regime at no increase in cost to the UK Exchequer.

Implementing changes to the new offshore funds regime:

Under the modernised regime for UK tax purposes, an offshore fund can elect to be a Reporting Fund. If it makes no election it is considered to be a Non-Reporting Fund. In determining whether to elect into the Reporting Fund regime, it is envisaged that the offshore fund will consider many factors including its investor profile and the assets into which it invests.

Anticipated Benefits and Costs

From discussions with industry the Government expects that the uptake of Reporting Fund status will be higher than the Distributor status it replaces. This combined with current market conditions (including a reduced number of fund launches, consolidation and product rationalisation) has made aggregate figures very difficult to quantify.

Consequently, our impact assessment focuses on a qualitative assessment of some of the potential costs and benefits arising from the new offshore funds regime.

Anticipated Benefits

Benefits to Business

Informed by discussions with industry to date, the Government expects there to be operational benefits and savings to industry in the areas set out below:

Funds will be able to elect in advance to have Reporting Fund status from HMRC. This will provide greater certainty for funds wishing to be Reporting Funds when compared to the existing distributor status which can only be determined in arrears. They will also be able to apply for Reporting status for indefinite periods, instead of the annual application required under the current regime. This is expected to reduce administrative costs.

- Funds will be less likely to lose their Reporting Fund status from inadvertent breaches. This will increase certainty for Reporting Funds.
- Abolishing the 5 per cent investments restriction test will provide more certainty to funds, as well as removing the need to monitor for tax purposes the underlying investments that it makes.
- It will no longer be necessary for an offshore fund requiring reporting status to carry out a full UK equivalent tax calculation. Instead it will adjust its total accounting return in line with prescribed rules to reach a reported income figure.
- A further simplification will be to remove the reinvestment mechanics required by the current rules.

Quantifying the value of these benefits is extremely difficult. Hence, the benefits have been scored as unquantified.

Anticipated Costs

There will be some small one-off costs incurred by: (a) the managers of funds, who will need to familiarise themselves with the new rules; and (b) HMRC, who will need to modify their administration and compliance processes to accommodate the changes to the tax rules. The Government anticipates that in total these one-off costs should be minimal.

Administrative Burden

HMRC is subject to quantified targets to reduce one aspect of compliance costs in particular; the admin burden on business of disclosing information to HMRC or to third parties. This burden is assessed through the 'Standard Cost Model', an activity-based costing model which identifies what activities a business has to do to comply with HMRC's obligations, and which estimates the cost of these activities, including agent fees and software costs.

Following from the above discussion, the measure is expected to lead to a reduction in administrative burdens. The Government has undertaken some initial analysis, based on a comparison of the obligations that funds have in terms of making applications and submitting the required information to HMRC under the current offshore funds tax rules, and the proposed modernisation. Based on this, we expect the value of the reduction in administrative burdens for the purposes of HMRC's targets to be negligible.

Benefits to UK Investors

The proposals for modernising the offshore funds tax regime will benefit UK investors by providing them with more certainty in terms of their tax treatment in comparison to the current offshore funds tax rules. This is because:

- UK investors can have greater certainty that they will be treated by HMRC as investing into a Reporting Fund in advance, whereas under the current regime the tax treatment will depend on whether a fund is awarded “Distributor status” at the end of the accounting period.
- Breaches of Distributor status conditions by an offshore fund can significantly affect UK investors. Since it is proposed that several of the tests, such as the investment restrictions test, will be removed, breaches of the Reporting Fund regime will be less likely.
- ‘In addition to this increased certainty, the abolition of the ‘material interest’ concept will make the taxation of interests in offshore funds easier to understand as all investors in a particular fund will be treated in a similar way.
- There will be increased certainty for ‘AIF equivalent’ offshore funds. The Government announced in Budget 2009 that it was minded to extend the provision of legislation to clarify whether certain transactions will be taxed as trading or investment for UK AIFs to equivalent offshore funds¹. The significance for offshore funds is that the characterization of their transactions as income or capital will affect their total measure of reportable income. This will allow the use of a ‘white list’ of financial transactions, which when undertaken will follow the accounting treatment.
- Finally, the proposals offer an opportunity for a more simplified and less burdensome tax regime for offshore funds wishing to market themselves into the UK. Subject to market conditions, the Government expects that at least some of those funds that currently do not have “Distributor Status” will choose to benefit and elect to be Reporting Funds, however this will be subject to the funds individual situation. If as predicted this occurs it will increase the choice that UK investors have when choosing which vehicles to invest in.

Specific Impacts Tests

Competition Assessment

The Government envisages that the reform proposals will have a small, positive effect on the UK retail investment market, particularly in terms of enabling new types of investment business to be sold into the UK market. The modernised regime offers an opportunity for a simpler and relatively less burdensome tax regime for offshore Reporting Funds.

Small Firms Impact

The Government has publicly consulted on the development of the modernised offshore fund regime with representative bodies, and directly with industry stakeholders. The AIF industry shows significant variation in the amount of assets managed by each fund, ranging from the few million pounds to over several hundred million. The proposals affect firms of all sizes and so the overall savings in terms of the administrative burden noted above are likely to be shared by small and large firms alike, subject to the number of funds operated by each firm.

Other Impacts

This measure has no impact on Race Equality, Disability Equality, Gender Equality or Human Rights. In addition, this measure has no or negligible impact on Legal Aid, Sustainable Development, Carbon Assessment, Other Environment, Health Impact Assessment or Rural Proofing.

¹ a “reporting fund” which meets the “genuine diversity of ownership” condition and is a “UCITS” or scheme recognised under “264, 270 or 272 of FSMA”

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

