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Sue Harper
Head of Collective Investments
Assets, Savings and Wealth Team
HM Treasury
1 Horse Guards Road
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9 January 2008

Dear Ms Harper,

Response to Consultative Document issued on 9 October 2007 in relation to Offshore Funds

1 As agreed at our meeting with you on 6 December 2007, we have set out below our comments on a number of the questions raised in the consultative document regarding the proposed offshore funds reporting regime.

2 Whilst we are broadly supportive of the proposed changes, we believe that a number of areas require further consideration in order to meet HM Treasury's ("HMT") objectives[1], being:

- Simplification of the operation of the offshore funds regime
- Providing more certainty to UK investors
- Parity between the taxation of offshore funds and UK funds
- Ensuring that the decision to invest offshore is made for commercial reasons and not tax reasons
- Ensuring the tax revenues of the UK Exchequer are not reduced

3 In formulating this response we have consulted widely with our broad investment management client base.

Point 1 – Characteristics based approach

4 We understand that HMT and HM Revenue & Customs ("HMRC") believe that a principles based approach rather than a prescriptive approach is necessary to fully achieve the aims of the offshore funds regime, and that it is not your intention to issue further detailed guidance on the application of each characteristic in draft legislation.

5 Our overriding concern is that the move to the characteristics based approach, as it is currently drafted[2], coupled with the abolition of the material interest test[3] will have adverse

[1] Paragraph 1.5 of Offshore Funds: a discussion paper (herewith referenced as "the consultative document")

[2] Section 2.3 of the consultative document

[3] Section 759 Income and Corporation Taxes Act 1988 ("ICTA").

consequences for a significant number of vehicles that do not fall within the current regime, but which could be brought into the proposed regime[4].

6 We believe that any broadening in the scope of the offshore funds regime will significantly increase the compliance and administration costs for the industry in seeking to understand the regime and implementing the consequential systems and reporting changes. We also believe that it will considerably increase the operational compliance burden upon HMRC.

7 Our specific comments are:

Application and interpretation of the characteristics

8 It would be more helpful if detailed guidance can be provided on the definition, application and relative importance of each of the characteristics.

Parity with UK funds

9 As a key HMT objective is to create parity of tax treatment between investment in an offshore and UK fund, we believe the regime should include only those offshore vehicles which by their nature are collective investment funds and are similar in substance to their UK authorised fund counterparts. Specifically, entities which are not, in commercial substance, fund vehicles should not be brought into scope.

The material interest test

10 In our view the material interest provision[5] should be retained as it sensibly excludes interests where there is no secondary market for the investment or where the value of the interest cannot be realised within 7 years (e.g. private equity and real estate funds), leaving such structures to be dealt with by existing tax legislation as appropriate (see comments below).

11 At the very least, grandfathering provisions should be introduced to phase in the abolition of the material interest rule. As a material interest is determined at the date of acquisition, we suggest that the current rules[6] remain in place for existing investors for at least 10 years. This will ensure that investors in current investment structures are not penalised by the proposed changes, and would be able to consider the appropriate structure for any new investments.

Interaction with existing UK legislation

12 Importantly, in many cases, existing legislation already ensures that an appropriate level of UK tax is charged on UK investors in offshore entities. Generally, arrangements which would fall within other UK tax provisions should be excluded from the proposed offshore fund rules to avoid creating additional complexity (with no additional tax take for the UK Exchequer). This is consistent with the comments in paragraphs 2.11 and 2.12 of the consultative document, which indicate that the intention is to exclude entities or arrangements from the regime where they are already subject to existing legislation.

13 Specific examples of the interaction of the proposed regime with existing UK anti-avoidance provisions are contained in Appendix I.

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[4] As noted in Section 2.14 of the consultative document.

[5] Section 759 ICTA

[6] Section 759 ICTA

Fund structures affected

14 As requested, we have set out in Appendix II some illustrative examples of the types of entities which are at risk of being classified as offshore funds, and why we believe they should not be.

Point 2 – Share class distinction

15 The ability of individual share classes to be regarded as separate offshore funds should be retained for the following reasons:

- Separate share classes are created for reasons other than UK distributor status (i.e. different allocations of performance fees / management fees or the operation of a fund or sub-fund in different currencies).

- UK investors requiring reporting fund status can be concentrated into a single share class, which can make the reporting/compliance process easier for administrators/fund managers.

Point 3 – Unit trust inclusion

16 Please refer to our comments in Appendix II in relation to the application of the proposed regime to unit trust schemes.

Point 4 – Transparent entities and impacts on other areas of the legislation

17 The consultative document suggests that transparent vehicles will be excluded from the new offshore funds regime. As discussed at our meeting, there are some circumstances where promoters of offshore funds may wish to have the choice of opting into the offshore funds rules.

18 In relation to your request for comments on Section 2.16 of the consultative document, please see our comments within Appendix I.

Point 5 – Upfront approval

19 It is not clear to us how the proposed system of upfront approval provides more certainty for fund investors and promoters, nor how the process interacts with the breach and revocation clauses in Section 3.31 of the consultative document.

20 The current annual certification process provides a degree of certainty to UK investors for each accounting period because the calculations of UK equivalent profits and distribution levels are certified annually. We understand that there will be no certification of reportable income, which will remove this level of certainty. Therefore, in our view, the current upfront "approval" process may be better termed an upfront registration. In order to ensure that this process does not impede the distribution or launch of new fund products, HMRC will need to provide more details of the pro-forma application required and commit to providing approval on a timely basis. In our view, it would be helpful if the approval process included a sign off in respect of the funds proposed reporting system and its methodology for the calculation of reportable income.

21 The reason for the commercial purpose test is unclear and we believe the test should be removed as it does not appear to capture any additional scenarios that other existing anti-avoidance legislation would not. Removal of the test would avoid creating uncertainty,

administrative costs and delays to market as a result of fund promoters having to consider this issue.

22 We note that when the offshore fund regime was originally introduced, it was specifically designed (a) to target particular types of investment vehicle and (b) to exclude a motive test on the grounds of simplicity.

Point 6 – Reporting to HM Revenue & Customs

23 As noted above, annual confirmations from HMRC will no longer be issued to confirm UK reporting fund status. A number of industry operators believe the current system provides a degree of certainty, and does not leave the fund's status open to challenge for a number of years in the future (refer to additional comments under Point 12).

Points 7 & 9 – Calculation of reportable income, deemed distributions and equalisation

Calculation of reportable income

24 Any changes which would simplify the current requirement to calculate UK Equivalent Profits ("UKEP") would be welcome. However, in our view, the proposals[7] do not appear to achieve any real procedural changes or reduction in the administrative burden.

25 Unless a more effective and efficient calculation/methodology is identified as an alternative to UKEP, we believe it would be preferable to retain the UKEP calculation, on the basis that the industry is now familiar with its requirements.

26 Our comments in this respect are:

Calculation methodology

27 The proposed regime[8] suggests that simplification can be achieved through increased reliance on the accounts of offshore funds, including the use of an equivalent to the IAS 'Total Recognised Income or Expense for the period' as a starting point for the calculation of reportable income. However adjustments are then anticipated for:

- expenses that are considered capital;
- Interest type returns (i.e. the calculation of effective interest);
- Derivatives
- net gains and losses on investments;
- There is a possibility for further adjustments for funds that operate equalisation arrangements (see separate comments below).

28 These are, effectively, the steps which need to be considered for a current UKEP calculation.

29 Also we note that under the current regime, reliance on the accounting treatment of loan relationships and derivatives is permitted where the funds' accounting treatment is broadly comparable with the UK Statement of Recommended Practice ("SORP") for UK Authorised

[7] Outlined in Sections 3.14 to 3.22 of the consultative document.

[8] Outlined in Sections 3.17 to 3.22 of the consultative document.

Funds. It is not clear to us how the suggested proposals to use IAS or an equivalent will interact with the current rules. Further, if wider stipulations regarding comparability to the UK SORP are introduced in draft legislation, this is likely to introduce additional administrative burdens for the industry, as mismatches will frequently occur as the UK SORP continues to be updated and amended.

Particular difficulty for real estate and private equity financing

30 If the current rules regarding comparability to the UK SORP are maintained (which have been very helpful for a number of funds) and the offshore fund rules are extended to private equity and real estate structures, a particular issue arises for these structures in relation to the calculation of their reportable income. Typically, such structures use significant amounts of debt financing to achieve tax efficiencies, and as a result many such funds extract capital gains in the form of interest payments. To the extent that the UK accounting rules treat returns from such debt as income without regard to the nature of the underlying economic gains (i.e. capital), this can result in an extremely adverse tax outcome for UK investors, as capital gains will effectively be converted to income. Therefore given the special nature of these funds we suggest that they should either be excluded from the proposals (refer to Appendix II for more detailed comments), or specific provisions are introduced which permit the calculation of reportable income to be based on the underlying nature of the return (i.e. capital gains).

List of approved GAAPs

31 Per the consultative document, if IAS is not used, the onus is on the fund to show that the GAAP applied produces an equivalent total return figure, before HMRC will 'approve' the GAAP, and begin to populate their list of approved GAAPs. Significant work may be required to reach this conclusion, which will initially increase administrative costs for fund houses.

32 In this respect you will note our comments under Point 5 which suggest extending the 'upfront approval' process to include a sign off on the methodology of calculating reportable income, which could include a process to "approve" the GAAP used where appropriate.

Parity with UK funds

33 Parity is not achieved because:

- UK funds do not have to consider tax adjustments in their distribution calculations, whereas, it is necessary for offshore funds to incorporate UK tax adjustments into the calculation of reportable income.

- The consultative document suggests that an adjustment will need to be made for performance fees to the extent they may relate to capital growth of the fund. Such fees are an allowable expense for UK funds and are specifically treated as deductible for the purposes of the "20% test" of the Investment Manager Exemption.

- The proposed calculation also brings capital returns in respect of investments in underlying bond funds into account as income each period, which is not consistent with the treatment of UK funds. For a UK fund, the loan relationship rules only bring amounts reflected as income in the accounts into tax each period, and capital amounts (e.g. offshore income gains) only become liable to tax on realisation.

Reporting reportable income / UK investor position

34 In our view, the requirement to report 100% of income returns will be highly problematic as:

- There is no margin for error in the calculation of reportable income which will lead to additional costs for fund houses as the calculation must be 100% correct. Currently, the 85% distribution requirement provides a degree of leeway to fund houses in relation to the calculations (e.g. to allow for minor timing adjustments or small amounts of income recorded in capital).

- A key concern is to avoid confusing investors as to what their taxable income is particularly where they receive both a cash dividend and notification of a deemed reportable income amount. In addition, as many funds will continue to make cash distributions, they will be very keen to avoid having to 'report' twice to investors on both cash and deemed distributions.

35 Therefore, we believe it is better to implement a system where the investor is taxed on the higher of 90% of reportable income or the cash distribution received.

Format of Reporting

36 Clarity is needed in relation to the format of reporting, in particular:

- The acceptable methods of making reports (i.e. vouchers, financial statements, website etc)

- What information is required?

- Where there is a mixture of cash and deemed distributions, an efficient system of reporting, such that large administrative reporting burdens are not introduced for very small additional deemed distributions (consider in conjunction with Point 10 below).

- Who will be ultimately responsible for making the report (given the custodian and not the fund will hold information on who the UK investors are)?

- That reports are only required for UK investors in the funds.

- Interaction with other reporting rules such as the EU Savings Directive.

Income equalisation

37 The present rules allow for accrued fund income included in an outgoing investor's redemption proceeds to count as a qualifying distribution, the quid pro quo being that this amount is taxed on the investor as income. The purpose of this provision was to enable funds that suffer significant redemptions in any period to maintain their distributor status. Without this provision, income equalisation paid to outgoing investors during the period might be viewed as a non-quallifying, capital distribution, making it difficult or, in extreme circumstances, impossible to meet the 85% distribution standard.

38 This mechanism is relatively trouble-free, as the income equalisation will simply be that accounted for naturally within the fund's systems, and the amount of the deemed distribution is just one component of the fund's total cash distributions that count towards the minimum distribution threshold.

39 It would in our view be highly undesirable if the move to a tax reporting regime required a fund to maintain a parallel, daily calculation of accrued income based on a UKEP or otherwise adjusted accounting basis of the type required for example for German tax reporting purposes. Experience there has shown this to be a highly onerous burden upon fund managers and administrators. If a suitable buffer were built into the tax reporting

requirements (we suggest 10% in the paragraphs above), this should enable income equalisation payments on redemptions during the course of a fund's accounting period to be subsumed within the overall reporting at the year-end. For any individual investor, the difference between income equalisation calculated by reference to the fund's accounting income, and equalisation calculated by reference to some tax-adjusted basis, should be sufficiently immaterial to dispense with the need for major systems work by fund sponsors and administrators.

Point 8 – Commodity funds

40 No comment.

Point 10 – Exclusion of de-minimis

41 In our view a de-minimis provision should be retained to ensure that funds do not have to report where there is minimal income in the fund, or where over 90% of reportable income has already or will be distributed in cash (refer to our comments in paragraph 35).

Point 11 – Removal of re-investment mechanics requirements

42 No comment

Point 12 – Breaches

43 Our comments are as follows:

- Where a serious breach has occurred because the offshore fund has not reported for practical reasons, e.g. no UK investors in the fund for a number of years, permanent loss of status appears disproportionate.

- Detailed guidance should be provided on what constitutes minor and serious breaches, and the proposed method to deal with each occurrence.

- As noted above, we understand that HMRC will introduce an audit process rather than a certification process for every fund. Clarity is needed on what action HMRC will take if an audit takes place some years after the period end and errors are identified (e.g. in what circumstances would the fund lose reporting fund status, is an additional report to investors required, how is equity achieved for new investors in the fund if additional reporting or payments are required? etc). The question then arises, if the fund wants to maintain reporting status, as to how it can appropriately adjust reported income as the result of an HMRC audit?

44 In order to limit difficulties that could be created by adopting an audit rather than annual approval process, we suggest that the “open” period during which HMRC may conduct an audit should be limited (e.g. to 1 year after the reporting date).

Point 13 – Investments in other offshore funds

<u>Minor portfolio investments in other offshore funds</u>

45 The proposal at Section 4.4 to abolish the 5% investment restriction is helpful for funds of funds, but would, without further provision, be potentially unhelpful for some other funds that happen to invest in other offshore funds as a minor and incidental part of their investment strategy. This is because the abolition of the investment restriction will require a fund manager to review every fund investment in the portfolio to determine whether it has UK

reporting fund status, which will be a costly and time consuming exercise. We note that a large number of funds invest a small percentage of their assets in other funds for entirely non-tax reasons (e.g. in order to access Asian or Middle Eastern equities a global equities fund may invest in an Asia fund rather than directly in Asian equities). In our view, a cumulative de-minimis limit of 10% of a portfolio should be introduced such that cumulative investments in other offshore funds that do not exceed 10% could be ignored. We note that a precedent for this approach exists in Austria where there is a 10% de-minimis level under which funds can ignore target fund investments (where target funds means other offshore funds in which they invest).

Fund of funds structures

46 The proposed fair value rules in respect of investments by reporting funds into other non-reporting funds have caused significant concern because:

- Realised and unrealised capital gains from underlying funds will be included in the reportable income of the reporting fund.
- Where the underlying non-reporting fund has substantial capital growth, this could cause a significant increase in the ultimate tax liability for the UK investor, perhaps without the receipt of any cash to fund the tax liability.
- Calculating the fair market value for funds that do not produce regular net asset values could be difficult.

47 Particularly, we believe this requirement will polarise the fund of funds market into fully reporting or fully non-reporting structures, as "mixed" fund of funds will be too difficult to operate. It is likely that a fair value approach for fund of funds investing in non-reporting funds would make such structures extremely unattractive to UK investors.

48 Our suggestions for alternatives to the fair value approach are as follows:

- It may be possible to impute a deemed percentage return for second tier investments, such that a simple, easily calculable figure is brought into account for the reportable income calculation of the reporting fund. There is general precedent for this approach in Europe.
- It may be possible to include an exemption for listed and actively traded vehicles at the second tier level, as outlined in the exchange traded funds section of Appendix II.

Parity with UK funds

49 We also note the following important considerations:

- The developing regime for UK Fund of Alternative Investment Funds ("FAIFs") will clearly be impacted by the provisions of the proposed offshore funds regime, particularly as regards investments in underlying alternative funds which may well be non-reporting. As discussed, it will be imperative that these two regimes are consistent, and also that the UK tax treatment of a UK FAIF is not seen to be more advantageous than that of an offshore fund of funds.
- As referred to under Points 7 & 9, where a reporting fund invests in a bond fund, the proposed regime states that the reporting fund will need to fair value its investment in the bond fund. This treatment is not comparable to that required of a UK fund.

Notional Reporting Funds

50 We believe the notional reporting fund option is unlikely to work in practice in the majority of cases because:

- Such funds are unlikely to have accounting systems set up to track income and capital separately. Even if the target fund and the investing fund are part of the same fund house access to sufficient information in order to be able to calculate UK reportable income may not be available.

- If the year end of a notional reporting fund differs from that of the reporting fund, questions arise as to when the income is deemed to be received by the reporting fund, i.e. when is the reportable date?

Point 14 – Reporting date

51 No comment.

Point 15 & 16 – UK individual and corporate investors position in reporting funds

52 No comment.

Point 17 – UK investor position where fund loses reporting fund status

53 No comment.

Point 18 & 19 – UK individual and corporate investors position in non-reporting fund

54 No comment.

Point 20 – Investor treatment where non-reporting fund becomes a reporting fund

55 No comment

Additional Point – Transitional Arrangements

56 We would like HMT to outline transitional arrangements for the implementation of the proposed regime to ensure that the effective date of implementation provides the industry with sufficient time to understand and implement the changes effectively. In particular, we suggest that for non-distributing funds which may now seek reporting fund status, an appropriate transitional provision would be to permit a deemed disposal and reacquisition of the interest, with any offshore income gain being rolled over until such time that the investment is ultimately disposed of (similar to general capital gains tax rollover provisions[9]).

If you wish to discuss any of the points raised in this letter please do not hesitate to contact us.

Yours sincerely,

Martin Smith – Tax Partner Elizabeth Stone – Tax Director

PricewaterhouseCoopers LLP

[9] I.e. - Sections 135 and 136 of the Taxation of Chargeable Gains Act 1992 ("TCGA")

Appendix I – Other UK anti-avoidance legislation

1 Examples of other UK tax provisions which impact on the structures referred to in Point 1:

- Section 13 TCGA
- Section 86 TGCA
- Section 87 et seq TCGA
- Schedule 4B TCGA
- Section 714 et seq. ITA[10]
- Section 747 et seq. ICTA

2 For UK corporate investors, the controlled foreign companies regime ("CFC") (to become the controlled companies ("CC") regime)[11] provides for UK corporation tax to be due on income accrued in offshore structures in certain circumstances. However:

- Section 5.10 of the consultation document in respect of UK corporate investors and reporting funds has no mention of how the proposed rules would interact with CFC/ CC legislation to avoid a double tax charge.
- Section 5.24: the same point arises in respect of UK corporate investors into non-reporting funds.

3 Therefore care must be taken when legislation is drafted to provide clarity over whether the CFC/CC regime takes precedence over the offshore funds rules, and to ensure that there will be no double tax charge. To assist with this, if the exclusion of groups (where the body corporate or 'fund' is in the same group as the operator) could be included within the proposed regime, this would specifically avoid the risk of double taxation in certain circumstances.[12]

4 Another key example where similar issues will arise is the interaction of the taxation of offshore income gains with Section 13 TCGA, where the fund would be a close company were it to be UK resident.

5 In connection with these examples, in Section 2.16 you invite comments on whether any other areas of the legislation will be directly impacted by the change in definition of an offshore fund. The additional sections of the UK legislation on which we believe the change will have a bearing are Section 842 ICTA as well as Sections 99 and 100 TCGA.

[10] Income Taxes Act 2007 ("ITA")

[11] Section 747 ICTA

[12] The exclusion was previously given in the definition of collection investment scheme within paragraph 10 of the Financial Services and Markets Act 2000 ("FSMA") (Collective Investment Schemes) Order 2001 (SI 1062/2001).

Appendix II – Examples of entities potentially caught by the new regime

Private Owned International Structures

1 It is difficult to provide simple categorisations of such structures as by their nature they are privately owned, bespoke complex structures that have been designed to meet the objectives of their investors; but importantly they have not been constructed as 'funds' for the purposes of being managed and marketed to the public. Some generalised examples are:

A. Offshore Trusts

2 These vehicles are used in a variety of areas of the asset management industry. For example, trusts can be deliberately created within the context of family arrangements or arise as part of wider commercial structures, while it is also possible for arrangements to arise in other jurisdictions which have the characteristics of pooling or trusts. Frequently, the analysis of such arrangements is complex but would not ordinarily meet the definition of an offshore fund under existing legislation.

3 When considering the characteristics under the proposed offshore funds regime, a number would apply; these arrangements may well be governed by foreign law, be resident overseas, they may have appointed a manager of the trust assets, not be transparent for some or all income and may indeed have fiduciary obligation to ensure that assets are appropriately diversified. Yet, importantly one characteristic is unlikely to apply as investors cannot usually expect to realise substantially the net asset value of their interest on disposal. As such, here it will be important to obtain clarity from HMT on whether it is the intention that all characteristics must be met for the vehicle to be an offshore fund.

4 It may be that, depending on the drafting of the proposed new legislation, no trust is effectively within the new regime. If this is not the case, the subtleties of trust arrangements must be further considered; most fundamentally that a beneficiary of a trust is not an investor. However, what about the position of a settler interested trust? In the context of a discretionary trust there can be no expectation of receiving any value. However, if the beneficiary has or is given an interest in the trust (including a right to income), the issues become more complex and careful drafting of the proposed legislation will be needed to ensure that an inadvertent charge to tax is not created.

5 Given the widespread use and occurrence of trusts, any new regime must clearly exclude arrangements which are not in practice offshore funds (refer to Point 1-Parity with UK Funds) or where the application of the offshore funds regime will make no difference to UK tax revenues, as a result of the application of existing UK legislation (refer to Point 1 – Interaction with Existing UK Legislation).

B. Private Companies

6 Issues will also arise in the context of investments in non-UK resident private companies. The nature and features of these investments will depend on the underlying circumstances. Typical examples could range from a family investment company for a wealthy overseas family (with some UK resident members) to an investment in an overseas holding company for UK employees (or indeed portfolio investors). It is possible that such entities will meet the revised characteristics. The companies will typically be incorporated and resident overseas, will not be transparent, will be managed by persons other than their shareholders, may well have more than one investment therefore spread risk, and on a theoretical winding up may be presumed to repay net asset value.

7 It may be that the intention of the characteristics is that the management of a company by its directors will not constitute the 'management of funds for investors' contemplated; which if directly stated would be welcome. However, it is not uncommon in offshore groups for one company to be contracted to carry out management of assets on behalf of others, and yet this company may not strictly be within the group as defined for UK tax purposes. This situation would appear to meet the characteristics stated (and not meet any exclusion for groups referred to in Appendix I if it were introduced), despite few if any of these structures falling within the current offshore fund regime.

8 Alternatively, it may be the intention that trading entities are to be excluded. This would be difficult to apply in practice and would also lead to the difficulty of how holding companies which do not trade themselves are to be treated. In this context, it should be noted that UK ordinarily resident individuals are in certain circumstances exposed to tax on the offshore income gains made within the overseas structures themselves (see section 762(5) ICTA 88) so that the gains made by overseas holding companies may still become chargeable depending on the precise scope of the new rules and 'characteristics' (refer to Appendix I).

Real Estate Structures

9 The changes could potentially bring many closed-ended corporate real estate structures within the proposed regime. The approach taken to establish whether corporate real estate fund structures would fall within the current regime is to consider the FSMA definition of a Collective Investment Scheme (as the majority of real estate funds tend to be 8, 10 or 12 year limited life funds due to the nature of the property cycle). Prior to the changes introduced by Finance Act 2007 it was generally possible to obtain a clear legal opinion that the real estate fund in question should not be an offshore fund by virtue of failing the investment condition of s236 FSMA, where there is no secondary market and redemption is not possible at the option of the investor. This became more complex following the enactment of Finance Act 2007; however the fact that investors coming in at inception would not have a 'material interest', in many cases assisted in obtaining comfort that the majority of offshore closed-ended corporate real estate fund structures are not within the present regime. Bringing real estate structures into the proposed regime would be to include entities which are generally created for the purposes of long term capital investment, and not on the whole for realisation of significant income returns.

10 In addition we note the draft Property Alternative Investment Funds ("PAIFs") regulations issued on 21 December 2007 stipulate that the two types of permitted investments are in non-resident Real Estate Investment Trust ("REIT") (which must be equivalent to UK REITS therefore closed-ended) or property held via a special purpose vehicle. If a stipulation is that UK PAIFs invest significantly in offshore closed-ended real estate structures it would seem to follow that such closed- ended offshore structures should be deemed to be outside the offshore funds regime to avoid complex interaction with the PAIFs regime. In relation to the special purpose vehicle stipulation, see the private equity analysis below.

Private Equity Structures

11 It would appear that the current majority of structures will not be unduly impacted to the extent they are structured as limited partnerships. The specific concern for private equity structures is how the proposed rules might apply to holding structures which typically sit immediately beneath a private equity fund as a means of holding portfolio companies.

12 As an example, a private equity fund will capitalise a Luxembourg company or a vertical chain of Luxembourg or Netherlands companies with the monies which are ultimately utilised in funding a Bid company to acquire a Target company. It is increasingly the trend

that a fund will have multiple investments held underneath a single Luxembourg company. This isn't necessarily with the aim of 'spreading investment risk', but as a matter of fact risk is spread for the Luxembourg company.

13 The absence of a clear delineation of the characteristics in paragraph 2.3, coupled with delegation by the boards of such Luxembourg or Netherland companies to varying degrees of day to day activities to third party affiliates of the fund's general partner, would create uncertainty on the application of the proposed regime for UK resident private equity investors. There are already anti-avoidance rules which apply to these structures beneath private equity funds. In as far as the private equity fund is a partnership, it seems counter-intuitive that the regime should not affect the fund, but will affect the layers of investment structures beneath the fund itself.

Exchange Traded Funds and other listed fund vehicles

14 Exchange traded funds ("ETFs") are hybrid fund vehicles which typically allow some significant institutional investors to redeem directly, while the remainder of the fund is traded on a stock exchange. Consequently, the traded 'retail' portion of the fund will typically track a value close to the net asset value ("NAV") of the fund, subject to brokerage fees and commissions, but not necessarily mirroring the NAV; in essence the fund has some open-ended and some closed-ended qualities. As such, under the new characteristics based approach, a key criterion is not met, and therefore there is a case to state that these vehicles should not be considered offshore funds to which the new regime will apply. A similar argument could be applied to all listed and actively traded funds.

15 Whether or not direct investment in such listed vehicles by UK investors is considered to be within the new regime, further thought should be given to how these vehicles should be treated at a target fund level i.e. where a reporting fund invests in an ETF or listed fund. In these scenarios, an assessment of whether the characteristics apply to the investment are potentially compounded by persons offshore in various jurisdictions attempting to interpret the characteristics, sometimes in relation to very small portfolio investments. In order to make the removal of the current investment restriction as useful and workable as possible, we believe it would be worthwhile considering whether there could be an exemption from the regime for reporting funds investing into ETFs, like vehicles or indeed any actively traded or listed funds (refer to our comments in Point 13 – Fund of Funds Structures) .