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Sue Harper
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11 July 2008

Dear Ms Harper

Response to Draft Statutory Instrument for consultation – The Offshore Funds (Tax) Regulations 2008 – May 2008

Please find below our comments on the partial draft regulations for the proposed new offshore funds tax regime.

1. Entry Into the Reporting Fund Regime – Part 4, Chapter 2

It remains unclear to us how the proposed system of upfront approval contained in Chapter 2 provides any significant additional certainty for fund investors and promoters, as it is currently drafted. In particular, given the introduction of the rules regarding breaches, we note that despite the upfront approval, a fund can still have reporting status revoked at any time if various annual requirements are not satisfied.

Further, we would draw your attention to the following:

1.1. Contents of application - Regulation 4.2.2

We note that Regulation 4.2.2(1)(d) requires a fund promoter to provide a statement specifying the figures in the funds' accounts that are considered to equate to "total recognised income and expense for the period" under International Accounting Standards ("IAS"). The following issues should be considered:

- For funds in offshore jurisdictions that do not currently implement IAS, the exercise to identify the IAS equivalent figure could prove onerous and costly. Further guidance on what might be considered the "equivalent figures" under the most common offshore Generally Accepted Accounting Principles ("GAAPs") would therefore be welcomed together with a list of acceptable GAAPS.

- Once work is undertaken to identify the IAS equivalent figure, further adjustments are still required to determine reportable income, which will mean further administration and costs for fund promoters. In our view, regulation 4.5.2 (2) should include an additional requirement to provide information about intended adjustments, so that Her Majesty's Revenue & Customs ("HMRC") could agree such adjustments as part of the upfront process. We believe that only then would the upfront approval process provide additional certainty for fund promoters.

1.2. Procedures for subsequently launched share classes / sub-funds

In addition, it is not clear to us how the upfront approval process will extend to new sub-funds and share classes launched in periods subsequent to the first period for which reporting fund status is sought. For example the following questions should be considered:

- Is it the intention that each new sub-fund or share class should undertake a separate upfront approval process?

- What should be the procedure where the introduction of new sub-funds (and investment strategies) may impact upon the offshore GAAP figure deemed to be equivalent to the IAS "total recognised income and expense for the period ".

1.3. Non-discrimination – Regulation 4.2.2 (e)

Regulation 4.2.2(e) requires a fund promoter to provide a statement that there will be no discrimination between participants between different classes of interest. This will effectively require a fund promoter to consider whether there is bona fide commercial purpose for different share classes or whether certain investors obtain a tax advantage (Conditions B and C in regulation 4.3.2).

It would be helpful if examples were provided as to the type of share class arrangements which Her Majesty's Treasury ("HMT") would regard as not having bona fide commercial purpose or which provide the investor with a tax advantage, given that HMRC are requiring that complex terms defined in UK tax legislation and case law are understood by persons located outside the UK.

2. Calculation of Reportable Income

2.1. Investments in other offshore funds

2.1.1. Income from bond funds – Regulation 4.5.6

We note the requirement in Regulation 4.5.6 that no adjustment to the "total recognised income and expense for the period" (or the approved equivalent thereof) is permitted for investments in "bond funds" (as defined in 4.5.6 (2)). We draw the following points to your attention:

- This treatment does not accord with the treatment of UK funds. In fact, as this regulation may result in a more adverse result for offshore funds, it could leave HMT open to challenges on the basis of EU discrimination and current case law relating thereto.

  The differential between UK funds and the proposed treatment for offshore funds arises because UK funds which invest in underlying bond funds recognise for tax purposes only those amounts that are recognised as income under the UK SORP. This means that any capital return from the underlying bond fund remains tax exempt.

- The proposed regulation also disregards whether the bond fund itself is a reporting fund. Where such a bond fund is a reporting fund and thus would be required to consider for itself the impact of effective yield in calculating its reportable income, it appears inconsistent to dis-apply this result and replace it with the UK corporation tax treatment for investments in bond funds.

- The regulation requires offshore fund promoters to fully understand the UK tax legislation concerning the definition of a bond fund. Again this places additional onerous administrative burdens and associated costs on fund promoters.

- Finally, imposing the definition of a "bond fund" within these rules appears incongruous with what we understand to be the reasoning behind the recent abolition of the UK tax credit available on dividends from all offshore funds. We understand that this action was taken because HMT were of the view that it would be too complex to apply the UK tax definition of a 'bond fund' to all offshore funds.

In our view, an offshore fund that invests in a 'reporting' bond fund should be permitted to adjust for capital components of the underlying bond fund return as determined by the UK SORP. This is consistent with the overall methodology for calculating reportable income as set out in Chapter 5 of Part 4 of the draft regulations.

2.1.2.Portfolio Investment

As noted in our submission dated 9th January 2008, the abolition of the investment restriction is helpful but we believe that further provision should be made in the regulations for offshore funds that have portfolio investments in other offshore funds.

As previously suggested, 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.

2.1.3.Reporting funds – timing of income recognition

Regulation 4.5.7A sets out the date of recognition by RF1 of income from RF2. In our view, these provisions appear unnecessarily complicated and would be simpler if they provided that:

- If the accounts of RF1 reflect the accrued income for the relevant period from RF2 then no adjustment is required; or

- If the accounts do not accrue income from RF2 then RF1 must recognise the reportable income from RF2 in the period in which RF2's distribution date falls.

We also note that there is no provision for the calculation of reportable income from RF2 where RF1 purchases and disposes of an RF2 investment within a single accounting period.

2.1.4.Non-reporting funds – deemed yield

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.

- For fund of funds, where there are losses in a deemed reporting fund in a particular accounting period, the reportable income will be nil. This is therefore disadvantageous because the loss is not available to offset against future income.

In our view, continued consideration should be given to introducing a deemed yield alternative.

2.1.5. Notional reporting funds – information required

We note Regulation 4.5.8 (particularly 4.5.8 (2) (c) & (d)) sets out the requirements for when an underlying investment in a non-reporting fund may be treated as a notional reporting fund. In our view further clarity is required on what level of information will be "sufficient" for these purposes, and what level of access to the accounts will be required. This additional clarity will be particularly important where reporting funds invest in third party non-reporting funds, which may be able to access some but not all accounting information.

2.1.6. Reporting, notional reporting and non-reporting funds – receipt of actual cash distribution

We note that the regulations do not appear to deal with the situation where RF1 receives a cash distribution from an underlying fund (which relates to the distributable income of the underlying fund) where RF1 has or will include an income amount relating to the same income in its own reportable income.

Regulations should be introduced that permit RF1 to operate an attribution account to ensure that there is no double-counting of reportable income where an underlying fund pays a cash distribution.

3. Equalisation

The draft regulations contain no rules in relation to equalisation and we understand that these will be published at a later date and will be based on the current rules for equalisation.

We note that equalisation under the new regime will come in two forms – equalisation on any physical distributions from the fund and equalisation on reportable income.

In our view, the report made to HMRC by fund promoters with details of the reportable income of a fund (refer below), should be required to include adjustments for equalisation amounts; that is, equalisation amounts on redemptions during the year should be treated as a deduction from the year end calculation of reportable income as they represent income of the fund that has, effectively, already been distributed to investors.

The 10% margin for error permissible in calculating the reportable income of a fund 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.

4. Reports to participants- Chapter 6

4.1. <u>Reported income for a period of account – Regulation 4.5.11</u>

The combined effect of Regulations 4.9.4 (2), Chapter 5 and 4.5.11 appears to suggest that the presumption is that a fund will report 100% of reportable income. We believe this should be made clearer in the Regulations, given the statements made regarding the 90% threshold within the 'Next Steps' paper of March 2008. However, we fully support the 10% margin for inadvertent errors, which was one of the points raised in our initial representation dated 9 January 2008.

Whilst we also note that HMT is still to provide regulations on the situation where cash is distributed in excess of 100% of reportable income (Regulation 4.7.5), further clarity will also be required where the actual income reported is 90% of reportable income, but a cash distribution of 100% of reportable income is paid. In our view it should be made clear that the investor should be taxed on the higher of two, up to a maximum of 100% of reportable income.

4.2. The report to participants – Regulation 4.6.1

4.2.1. *Format of reporting*

Clarity is still required in relation to the acceptable formats for reporting to investors. Whilst the suggestion of using financial accounts to disclose such information is welcome, many funds may find this difficult in practice due to regulatory deadlines for completion and publication of their financial statements. Therefore, in our view it is important that other methods of disclosing information to fund investors are available, and that these are as efficient and user-friendly as possible.

4.2.2. *Who are the participants?*

It is clear that where a fund pays a cash distribution equal to reportable income, that the relevant investors to whom the information (reportable income) must be reported are those investors in the fund at the official ex-dividend date. The regulations do not address the situation where a fund does not pay a cash dividend and therefore has no official ex-dividend date applicable to the reportable income amount. For example, if a fund reports income 4 months after year end, an investor is deemed to have received the income at that time, but the regulations do not make it clear whether it is referring to investors in the fund at that time or in the fund at the prior year end.

We note that UK accumulating authorised funds are already required to deal with this issue, as their UK investors are taxed annually on deemed distributions. Such UK funds have a formal income allocation date, typically included within the fund constituent documentation. However, in contrast offshore funds are unlikely to have dealt with this issue to date, nor have appropriate clauses in their fund documentation. Therefore, we recommend that the regulations should specify an income allocation date to deal with this situation.

It should also be made clear that where a fund pays a cash distribution in relation to a period of account which is less than the reportable income for that period, that the relevant investors to whom an additional report must be made are those investors entitled to the receipt of the cash dividend.

4.2.3. *Requirement for funds to identify when they become a 'bond fund'*

We note regulation 4.10.1 requires that as part of the report to investors a fund must consider each period whether it would be classified as a bond fund for UK tax purposes. Should this be the case (at any point during that relevant accounting period) for that period and all subsequent periods the fund must then identify on its report to investors that it is a bond fund.

Consequently, it is still required to fulfil reporting requirements for its UK investors which are subject to income tax, while its UK investors subject to corporation tax must disregard reportable income and apply standard corporation tax rules. This appears overly complicated and again requires offshore persons to understand the complex definition of a bond fund under UK tax legislation and case law.

5. The Provision of Information to HMRC – Chapter 8

5.1. Annual reporting requirements – Regulation 4.8.1

Regulation 4.8.1(1)(c) requires fund promoters to report the names and addresses of each UK participant in the fund, together with the reported income for each participant. Regulation 4.8.1 (c) also requires computation of the reported income of each UK participant which effectively requires the fund promoter to identify how many units each investor holds for the relevant period. In our view, it is likely that fund promoters will have considerable difficulty in complying with these requirements because:

- they significantly increase the information funds need to provide and are likely to increase administration costs and the complexity of the compliance process;

- they may have no knowledge or information about the ultimate UK investor or the aggregate number of units held by each investor (e.g. because the investment is held via a nominee account); or

- they are prevented by local data protection or banking regulations which prohibit the dissemination of such information.

If this requirement remains it is likely that it will have a seriously adverse impact on the number of funds seeking UK reporting fund status, thus reducing investment choice for UK investors.

We also note that this requirement is at odds with the position for UK-based funds. UK-based funds are obliged merely to furnish their investors with sufficient information to enable them to complete their personal tax returns correctly, and, their responsibilities end there. They are entitled to assume that their investors will apply the information the fund has provided to them in completing their personal tax returns honestly and accurately.

If HMRC wished to obtain from a UK-based fund details of its investors, an Inspector of Taxes would have to persuade a Special Commissioner to authorise the issue by HMRC of a statutory information notice to the fund, under Section 20 (8A) of the Taxed Management Act 1970 ("TMA"). In order to persuade a Special Commissioner to authorise the issue of a Section 20 (8A) TMA notice, HMRC would have to demonstrate that (i) there were reasonable grounds for believing that any of the class of taxpayers to whom the proposed notice related might have failed, or might fail, to comply with any provision of the Taxes Acts; and (ii) that any such failure was likely to have led to, or to lead to, serious prejudice to the proper assessment or collection of tax.

It is not apparent to us why there should be such a wide gulf between the approach that is adopted for UK-based funds (who will have to disclose investor details only in the event that HMRC undertakes an extraordinary procedure, in the face of real evidence that there is an underlying risk of loss of tax to the exchequer), and the approach that is being proposed for offshore funds (who will have to disclose investor details automatically, every year).

There seems to be no proportionality between:

- the additional burden being placed on offshore funds as compared to UK-based funds; and
- (ii) the additional risk (of non-compliant investor behaviour) that can reasonably be supposed to attach to offshore funds as compared to UK funds."

We therefore believe that this requirement should be removed from the regulations, due both to the inherent complexities involved if fund promoters are required to provide this information, and to the lack of consistency with the requirements for UK funds.

Finally, with such stringent information requirements imposed for each "UK participant", we note that a "UK participant" is not defined within the regulations. Should it be assumed that this would relate to UK tax payers? If so consideration should be given to how a fund manager may be able to identify which investors are indeed UK tax payers.

5.2. Information powers

Regulation 4.8.2 (1) grants HMRC significant powers to request information under the draft regulations. We note that these provisions seek to extend HMRC's jurisdictional reach by requiring entities domiciled, tax resident and / or managed outside the UK to provide information.

Depending on how these powers are intended to be exercised in practice, this may increase the administration costs of obtaining reporting fund status. This may be a deterrent to funds applying for reporting status and as such reduce UK investor choice. Additional clarity on what records HMRC would seek to gain access to when these information powers are exercised would be helpful.

6. Breaches – Chapter 9

6.1. Three breaches rule – Regulation 4.9.2(3)

In our view regulation 4.9.2(3) is excessive. We can envisage situations where over a 10 year period a fund house may have more than 3 minor breaches due to a variety of factors such as new investment instruments, new accounting treatment of existing instruments, change in administrators etc., none of which are tax avoidance driven and therefore the reasons for each breach would be regarded, objectively, as reasonable. We believe each breach should therefore be considered on a stand alone basis. If an error results from systemic errors by the manager / administrator then one possibility could be that reporting status is suspended until such time as agreement is reached between HMRC and the fund promoter regarding appropriate systems changes.

If the 3 breach rule is retained we believe that due to the complexities and uncertainty in implementing any new tax legislation, it would be inappropriate to include inadvertent breaches which occur in the first three years after the introduction of the new reporting rules in the 10 year period.

6.2. Failure to provide information – Regulation 4.8.2 (2)

As noted above, regulation 4.8.2 (1) grants HMRC significant powers to request information under the draft regulations. Failure to provide such information within 28 days or appeal the information request within 42 days will result in a major breach and therefore irrevocable loss of reporting fund status.

We believe that the loss of reporting fund status is entirely disproportionate to the "mischief" that HMT is seeking to prevent. In our view it may be difficult in practice for many funds to comply with a 28 day time period particularly as a significant amount of fund activity (and therefore information) is outsourced to external service providers, who may be located outside the UK.

7. Investor Election - Change of Reporting/Non-Reporting Fund Status – Regulations 3.7.2 and 4.7.7

The investor elections contained in regulation regulations 3.7.2 and 4.7.7 are a welcome development but as noted in our previous submission we believe strongly that an investor should be able to roll over any accrued gain until such time that the interest in the offshore fund is disposed of.

We also note that sections 135 and 136 TCGA 1992 permit, in certain circumstances, the rollover of any capital gain where a fund merger takes place. However, these sections do not apply where a reporting fund merges with a non-reporting fund. We note that the regulations do not provide any facility for an investor in these circumstances to make an election to preserve capital gains tax treatment where the fund becomes a non-reporting fund as a result of a merger.

8. Investor Submission to Obtain Reporting Fund Status

We note that there is no provision for investors themselves to submit an application for a fund to obtain reporting status, as there is with the current distributing regime. This may be a disadvantage for investors where there are only a small number of investors and therefore the fund does not apply itself to join the regime.

In addition, the fact that errors by the fund manager, administrator or other service providers or failure to provide information could result in a loss of qualifying fund status penalises investors. In such cases, we believe that investors should, on an individual basis, be able to seek qualifying fund status for their investment.

9. Transitional Rules

We note that the partial draft regulations do not yet cover any transitional provisions. We provide the following suggestions:

- In our view, funds already within the distributor status regime should be granted a simplified upfront approval process upon transition into the new regime. We believe this would be appropriate because the very fact that the funds have obtained distributor status means that HMRC has already reviewed the constituent documents of the fund and has certified that it is satisfied that the appropriate accounting methodologies have been used and UKEP adjustments have been made in relation to fund investments.

- For funds which currently apply for certification as a distributing fund, we would recommend that the new regime should apply for accounting periods beginning on or after the date that the new regime comes into force.

- We believe that an election for early adoption of the new regime would be beneficial for a number of funds and would reduce the administrative burden in complying with the new regime. For example, funds that commence shortly before the new regime is effective may have to apply for both distributor status for a short period and then apply for reporting fund status shortly afterwards. An early adoption election would mean that new funds could apply only for reporting fund status and would not need to additionally apply for distributor status if their accounting period spanned the start date of the new regime.

10. Removal of de-minimis

The absence of a de-minimis test in relation to the reporting process for negligible income is likely to increase the administrative burden and costs for fund promoters while having a very minimal impact upon the tax revenues for HMT. In our view, a de-minimis test similar to that in place under the distributing regime should be maintained.

11. Charitable investors

The draft regulations state that a charity will be exempt from corporation tax on an offshore income gain if the gain is applied for charitable purposes. However, where a fund is only reporting income, and is not distributing the income in question to investors, the undistributed income cannot be applied for charitable purposes. Therefore it appears that under the draft regulations as they stand a charity would be taxable on the reported income if it is not distributed, which we assume is not the intended policy result.

12. UK Life insurance companies investing into offshore funds

We understand that HMRC have informally indicated that Section 212 of the Taxation of Chargeable Gains Act 1992 should apply (and the offshore funds rules should not apply) for investments into all collective vehicles which are not transparent for UK capital gains tax purposes. We would be grateful for additional clarity on whether this will be addressed within the Regulations or under separate cover.

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

Yours sincerely,

Elizabeth Stone – Tax Partner

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