

## The new **Offshore Funds** regime is now with us: what does it mean for property funds?

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### **Purpose and effect**

The new regime came into effect on 1 December. Its purpose remains as before: to prevent the conversion of income into capital gain by rolling up income offshore in a tax free (or lower tax) environment and then distributing it in capital form. With the differential between the UK capital gains and income tax rates, this is one of the ways HM Revenue & Customs (HMRC) seeks to prevent abuse.

The potential effect is still the same: UK resident investors in an offshore fund may be taxed on gains on the disposal of their interest in the offshore fund as income rather than capital gain.

### **What is an offshore fund?**

The definition of an offshore fund was changed in the Finance Act 2009. It includes a non-resident body corporate, trust or other arrangement which create rights in the nature of co-ownership (but not a partnership) where the investors

- participate in, or receive profits or income from, the acquisition, holding, management or disposal of fund assets (including real property assets)
- do not have day-to-day control of the management of the fund assets
- and, under the terms of the arrangements, can reasonably expect to be able to realise all or part of their investment on a basis calculated entirely, or almost entirely, by reference to the net asset value of the fund assets, or an index of any description.

On the face of it, the rules appear to apply to any non-UK resident property vehicle formed to pool investors' money to acquire UK or non-UK property assets on their behalf. However, the rules are designed to apply to open ended companies. Non-UK investment fund vehicles that are equivalent to UK Property Authorised Investment Funds are within the definition of an offshore fund (but those that are equivalent to UK Real Estate Investment Trusts are not).

The rules may also apply to a closed-ended non-UK resident company (a company with fixed share capital) if it has the characteristics of an open ended company (which is a company with share capital that expands and contracts with demand). As most property funds have a limited life, investors in these funds may well have a reasonable expectation of receiving net asset value on the winding up of the fund and so be regarded as falling

within the offshore fund regime. However, if the fund is not designed to wind up, dissolve or terminate on a specified date, or a date that is determinable by a reasonable investor when the fund is set up (or where relevant, when reconstructed), then, subject to meeting certain other conditions, it should not generally be within the rules.

### **So what else has changed?**

The charge to tax on offshore income gains previously applied when there was a disposal of a 'material interest' in an offshore fund which was classified as a non-distributing fund. A material interest existed if, on acquisition, the investor could reasonably expect to realise the value of their investment within seven years. There is now simply a charge to tax on an offshore income gain generally whenever there is a disposal of an interest in a non-reporting offshore fund by a UK resident investor.

The distributing fund regime has been replaced by the reporting fund regime. Under this regime, the general position is that gains realised by UK resident investors on the sale of an interest in a reporting fund will be taxed under capital gains rules. From an investor's perspective, the essential difference between the reporting and distributing fund regimes is that they will now be taxed on income of the fund, whether or not the fund chooses to distribute its income.

Distributing funds which become reporting funds for their first accounting period beginning on or after 1 December (or for the succeeding accounting period if the election, referred to below, to defer entry is made) will be treated as if they had always been a reporting fund. Non-distributing funds will be treated as non-reporting funds unless and until they apply to become reporting funds. There is an election mechanism available to protect investors' capital gains position when a non-reporting fund becomes a reporting fund and vice versa. This is designed to ensure gains accrued whilst a fund is a reporting fund are taken outside the scope of the offshore fund rules if the fund has been a non-reporting fund (including a fund which was previously a non-distributing fund) and to preserve capital gains treatment for inherent gains where a reporting fund (or a fund that was a distributing fund under the old rules) becomes a non-reporting fund.

## Becoming a reporting fund

If a fund is within the offshore funds regime, its fund manager must apply within 3 months of the start of the accounting period for it to become a reporting fund for that period. In the application, the manager must

- state the first period of account for which it is to be a reporting fund
- undertake that no period of account will exceed 18 months
- confirm that international accounting standards (or not applicable, which generally accepted accounting practice) will be used
- undertake to provide the information required to be provided to investors and HMRC under the reporting fund regime on time
- provide a copy of the fund prospectus.

The earliest an offshore fund can join the reporting fund regime is with effect from the start of the first accounting period beginning on or after 1 December 2009. It will then remain within the regime until the end of the accounting period specified by the manager in a notice to withdraw from the regime, or if HMRC gives notice that it can no longer be within the regime due to a serious breach of the regime requirements.

Property funds already certified as distributing funds can apply to be certified as distributing funds for the accounting period straddling 1 December 2009 and can delay their entry into the reporting fund regime by electing to remain distributing funds for the following accounting period. This may be beneficial in some cases.

## Obligations of reporting funds

A reporting fund must

- prepare accounts in accordance with the requirements of the regime
- provide a computation of reportable income of the fund, making the detailed adjustments required
- provide a report to all UK resident investors within six months of the end of the reporting period stating the amount of income distributed, the dates distributions were made, the excess of reportable income over distributions made and that the fund is a reporting fund
- provide all of the required information to HMRC within the same time period which includes its audited accounts, the computation of reportable income, a copy of the investors report, and a declaration that the fund has complied with its obligations under the reporting fund regime.

## Is there any good news?

Yes. Generally, offshore unit trusts that are structured as transparent for UK income tax purposes do not have to apply to become reporting funds to preserve the benefit of capital gains treatment for their investors. Even

though technically such a unit trust will be a non-reporting fund under the new rules, investors in transparent funds will not realise an offshore income gain on disposal of their interest in the fund provided the fund provides sufficient information to its investors (UK and non-UK) to enable them to comply with their UK tax obligations. This is good news because offshore property unit trusts are commonly used as vehicles for holding UK property and previously faced an unnecessary burden of compliance with the distributing funds regime. Now this burden will be removed for most offshore property unit trusts as long as they do provide information to their investors to enable them to complete their UK tax returns.

However, there is a very important exception to this. An offshore property unit trust will need to become a reporting fund (or its UK investors will be exposed to tax on offshore income gains) if more than 5% of its assets by value have at any time been non-reporting funds (including other transparent funds). This makes dual or multi-tiered offshore property unit trust structures unattractive as holding (and any intermediate) unit trusts will need to apply for reporting fund status.

## What should you be doing?

The offshore fund rules are complex. We recommend that property fund managers should take professional advice where required and

- review the structure of the offshore property fund(s) they manage to establish if the offshore fund rules apply
- consider if and when an application should be made for a fund to be a reporting fund for accounting periods beginning on or after 1 December 2009 and the implications for investors
- if relevant, make the applications within the prescribed time limit
- inform UK resident investors of the need to make an election if a former non-distributing fund becomes a reporting fund or a distributing fund becomes a reporting fund
- put in place procedures to ensure on going compliance with the reporting fund regime.

If you are used to making applications for distributor fund status, then for the accounting period of a fund which straddles 1 December, an application for distributing fund status may still be necessary. This will also be the case for offshore property unit trusts even where they do not need to apply to become reporting funds under the new regime if investors have or are likely to dispose of their interests in the fund in the accounting period beginning before 1 December.

**Who should I contact for assistance?**

If you would like to discuss any of the matters raised in this fact sheet, please contact Marion Cane or Anne Stopford.

**Contact**

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