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Investment Management and Hedge Funds Alert

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New UK Tax Regime for Offshore Funds Provides Opportunity for US-Managed Funds

On October 1, 2009, a new regime governing the tax liabilities of UK-resident investors in offshore funds is expected to go into effect.

An overhaul of the UK tax rules on offshore funds was first announced in 2007 and has been the subject of a lengthy consultation process. The new legislation was outlined in K&L Gates' Investment Management Update (Fall 2008). This Alert provides more detail on the new rules and explains a new opportunity to manage a master-feeder fund structure that addresses the needs of both UK and US investors.

Current requirement to distribute income

Under current rules, the tax treatment of returns realized by UK tax-resident investors in an offshore fund depends on whether the fund is a "distributing fund." To be a "distributing fund," a fund must distribute at least 85% of its income (not including investment gain) in each accounting period. The 85% refers to all income of the fund, not just 85% of income to which UK investors are entitled.

If the fund is a "distributing fund," any gain realized by a UK investor as a result of selling or redeeming an investment in the fund should be taxed under the capital gains tax rules. Gains on investments in funds that are not "distributing funds" are classified as "offshore income gains," which are treated as income of the investor when the gains are realized.

For individual UK investors, being subject to capital gains tax rather than income tax is advantageous in terms of rates of tax. In April of 2008, the relative attractiveness of capital gains treatment became even more marked: a flat capital gains tax rate of 18% for individuals was introduced. This new rate replaced an incremental 24%-40% for investments, and compares very favorably with the 40% income tax rate that a higher-rate individual taxpayer would pay on trading profits (including offshore income gains).

Trading profits are considered income that must be distributed by a "distributing fund," while gains realized on a fund's investments do not need to be distributed. This provides an incentive to manage an offshore fund having UK investors so that its gains result from investment rather than from trading activity. Such an investment style allows a fund to achieve "distributing fund" status while minimizing the amount of actual distributions. This incentive collides with the preference of funds managed for US investors to engage in trading activities for purposes of allowing fund expenses to be deducted as business expenses rather than as investment expenses, as investment expenses are miscellaneous itemized deductions with respect to US individual investors and are subject to a number of limitations.

New reporting fund regime

Under the new regime, the requirement to distribute income is being withdrawn. Starting October 1, 2009, offshore funds will instead be classified as "reporting" or "non-reporting" funds for UK tax purposes. Reporting funds will be able to offer UK investors capital gains tax treatment on exit in the same manner as distributing funds currently offer.

A reporting fund will need to report all its income to its investors, in each accounting period, subject to a 10% margin for error. UK investors will include their share of the reported income in their tax returns, whether or not distributed. Although there will be no legal requirement on a fund to distribute any of its income to be classified as a reporting fund, in practice it may want to distribute at least enough to enable UK investors to pay the income tax on their reported income.

The requirement to report all the income of a fund will have no impact on investors who are not tax-resident in the UK. It will not make them liable for UK tax for which they would not otherwise be liable.

The distinction between trading profits, which will constitute reportable income, and investment gains, which will not, will continue. The switch from a distribution requirement to a reporting requirement, however, will make it easier for a fund that engages in a high level of trading activity to provide the benefits of the lower capital gains tax rate to its UK investors on exit, as the fund will not need to distribute 85% of its trading profits. A trading-oriented master-feeder fund will also be able to provide the benefit of the business expense deduction to its US investors, while making reporting fund treatment available to any UK investors in its offshore feeder.

It is anticipated that a reporting fund's accounts will be prepared in accordance with International Accounting Standards, though the UK Government has made it clear that it will permit the use of other GAAPs if it can be shown that they produce an equivalent figure for reportable income. Thus it would be possible for a US-managed fund to apply for reporting status on the basis that its accounts will be prepared in accordance with US GAAP.

Certification as a reporting fund

At present, an application to HM Revenue & Customs to be treated as a distributing fund must be made for each accounting period. The application must be submitted within six months of the end of the accounting period.

Under the new rules, offshore funds wanting to offer their UK investors capital gains tax treatment on exit will be able to apply in advance for certification as a "reporting fund." In subsequent accounting periods, reporting funds will need to make filings and submit accounts for "reporting fund" status.

For the first accounting period in which a fund will qualify as a reporting fund, the application must be submitted to HMRC within three months after the beginning of the period.

Comment

The UK Government has heralded the modernizing of the current offshore fund rules, which were originally introduced in 1984 and were not developed with the hedge fund industry in mind. The new rules make it feasible for hedge funds to qualify for "reporting fund" status. Managers of hedge funds should be considering now whether "reporting fund" status is desirable and achievable for their UK investors.

For more information on the UK tax issues raised in this alert, please contact Oliver Gutman at oliver.gutman@klgates.com. For more information on the US tax issues raised, please contact Roger Wise at roger.wise@klgates.com or Joel Almquist at joel.almquist@klgates.com.

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