EXPLANATORY MEMORANDUM TO

THE OFFSHORE FUNDS (TAX) (AMENDMENT) REGULATIONS 2014

2014 No. 1931

1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs (HMRC) on behalf of the Treasury and is laid before the House of Commons by Command of Her Majesty.

2. Purpose of the instrument

2.1 These Regulations amend the Offshore Funds (Tax) Regulations 2009 (S.I. 2009/3001; "the 2009 Regulations"), which make provision for the tax treatment of participants in offshore funds.

2.2 These Regulations affect alternative investment fund managers (AIFM) that operate as a partnership and have an interest in an offshore fund.

2.3 These Regulations clarify the period of ownership used in determining the tax charge on an interest in an offshore fund if that interest represents a profit share of a member of an AIFM partnership that is allocated to the partnership under new section 863I of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA 2005).

2.4 The Regulations also dis-apply the election under the 2009 Regulations to be taxed on a different basis before the member of the AIFM partnership receives the income.

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

3.1 None

4. Legislative Context

4.1 The instrument modifies the law relating to the taxation of offshore funds in which members of AIFM partnerships have an interest and they are also using a new AIFM mechanism introduced as part of the Finance Act 2014 (Part 3 of Schedule 17).

4.2 The regime for taxing interests in offshore funds was first introduced in 1984, aimed at ensuring that all UK investors would pay tax annually on income from their funds, irrespective of whether the funds were UK or offshore funds. The rules were substantially revised in 2009 to divide offshore funds into:

- reporting funds, which facilitate "roll up" of income but report income as it arises to ensure that UK investors are still taxed in a similar way to investors in UK authorised funds; and

- non-reporting funds, which choose not to report and therefore allow income to be rolled up untaxed in the fund but where any subsequent gain on disposal is taxed as income.

4.3 Under the 2009 Regulations, where an investor in an offshore fund disposes of the investment, the tax consequences differ depending on whether the fund was a reporting fund or a non-reporting fund at the date of disposal.

4.4 Investors in reporting funds are taxed on the gain in the usual way (usually, as a capital gain subject to CGT). Investors in non-reporting funds are, under the 2009 Regulations, chargeable to tax on an "offshore income gain" or OIG. If the fund has converted to a reporting fund during the investor's period of ownership**1**, the investor still has an OIG but has a right to elect to make a notional disposal at market value at the date of conversion, pay tax at income rates on the notional gain to date and then pay CGT on any further gain.

4.5 This instrument makes minor changes to the regulations 17 and 48 of the 2009 Regulations to ensure that where profits have been allocated to an AIFM partnership under section 863I ITTOIA 2005 then:

- the material period for taxing these interests should start from the date when the variable remuneration is awarded to members of the AIFM partnerships and not when it is received (i.e. not when it vests with those members); and
- these members cannot elect under the 2009 Regulations to be taxed on a different basis before the remuneration is received.

The effect of this amendment is that if the fund has converted from non-reporting to reporting fund status during the material period, the entirety of the gain is taxed as income under the OIG rules.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

7.1 The Partnerships Review measure has two strands: the first deals with the disguising of employment in limited liability partnerships while the second seeks to prevent tax-motivated allocations of business profits and losses in mixed membership partnerships (typically individual and corporate partners).

1 This is the "material period" as defined under Regulation 17 of the 2009 Regulations: "the acquisition of the asset or on 1st January 1984 (whichever is the later) and ending on the day on which the fund became a reporting fund".

7.2 The interaction of an EU Directive on AIFMs (AIFMD) with tax and NICs rules means that members of AIFM partnerships would be subject to tax and NICs on certain profits they cannot access at the time the liability arises, because these profits will be deferred by 3-5 years in accordance with the AIFMD rules. Legislation introduced in the Finance Act 2014 addresses this issue without allowing the continued use of corporate partners as this would give rise to tax advantages which the second strand of the partnerships measure will prevent.

7.3 If an AIFM partnership has made an election for these special tax provisions to apply, a member in the partnership may allocate profits to the firm, and the partnership will be liable to income tax at that time. Those allocated profits may subsequently vest in the individual member, at which time no further tax is payable.

7.4 The Regulations make related consequential changes in relation to any offshore fund interests which members of AIFM partnerships hold using profits arising to them that they allocate to the partnership under these new AIFM provisions. The aim is to prevent tax loss that may arise in certain complex arrangements.

Consolidation

7.5 There are currently no plans to consolidate the instrument that is being amended.

8. Consultation outcome

8.1 HMRC carried out a formal consultation between May and August 2013 on changing certain partnership tax rules - *Partnerships: A review of two aspects of the tax rules:*
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/200503/130520_Pships_Condoc_FinalVersion.pdf

8.2 About 110 responses were received. A response document was published last December (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/264652/partnerships_-_a_review_of_two_aspect_of_the_tax_rules.pdf) alongside draft Finance Bill 2014 legislation. They set out the new AIFM provisions and were well received.

8.3 Technical consultation on this draft legislation concluded on 4 February 2014. Revised draft legislation was published as part of Finance Bill 2014 on 27 March 2014 and Royal Assent was received before the summer recess.

8.4 This instrument makes minor changes to the 2009 Regulations that mirror the principles and design of the new AIFM provisions and prevents tax loss. No further consultation is required.

9. Guidance

9.1 The latest guidance on the new partnerships legislation made as part of the Finance Act 2014 was published on 27 March 2014 and is available on the GOV.UK website: https://www.gov.uk/government/publications/mixed-membership-partnership-aifms-and-asset-disposal-rules-legislation-day-technical-note-and-guidance

9.2 The offshore fund manual will be updated to reflect the changes in the instrument in due course.

10. Impact

10.1 There will only be an impact on alternative investment managers who operate as partnerships and invest in offshore funds. The impact on business overall, charities, voluntary bodies or the public sector is negligible.

10.2 The Partnerships Review measure comprises a number of elements which will bring in total tax and NICs revenue of £3.27 billion over the forecast period to 2018-19. A Tax Information and Impact Note was published last December 2013: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/264620/4._Partnerships.pdf It remains an accurate summary of the impacts that also apply to this instrument which is a mirroring provision.

11. Regulating small business

11.1 The legislation applies to small business as this instrument will impact across the alternative investment fund sector. However, there will be minimal impact on small business as this legislation only makes consequential amendments to existing legislation.

12 Monitoring & review

12.1 The purpose of this instrument is to bring certainty and consistency in the tax treatment of AIFM partnerships irrespective of whether they invest in offshore funds.

12.2 HMRC will monitor the effectiveness of this instrument to ensure the Government objectives are met.

13. Contact

13.1 James Ewington can answer any queries regarding the instrument (Tel: 03000 553 788 or Email: James.Ewington@hmrc.gsi.gov.uk).