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Mr Richard Thomas  
HMRC (CT & VAT)

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Dear Richard

### **Offshore funds and charities: Partial Draft Regulations issued in May 2008**

Thank you for your e-mail of 22 July 2008 requesting further clarification of the points made to your colleague, Sue Harper, in our response to Offshore Funds: Partial Draft Regulations issued in May 2008 (sent to you on 15 July 2008).

In summary, we believe that the offshore funds regime should exempt charity investors on the basis of their realised income and gains. A realised basis is simple to apply, results in the fair reporting of the real investment return achieved by the charity and enables its application to charitable purposes to be more easily verified. We believe that this makes sense in the context of the Government's objectives.

To put matters in context, the aim of the offshore funds regime is to prevent UK investors from converting income into capital gains that are taxed more favourably, essentially by means of the roll up of undistributed income. The legislation in fact goes further, in that it taxes as income the whole of the return on an investment in a non-distributing fund, including capital growth as well as the accumulation of undistributed income. But in either case a charity investor obtains no tax advantage by investing in an offshore fund, as charities enjoy a general exemption from tax on their worldwide investment income and capital gains, provided that they are applied to charitable purposes. That this is accepted is implicit in the existing exemption of charities from the tax charge on offshore income gains (OIG) in Income and Corporation Taxes Act 1988 (ICTA) section 761(6) and Income Taxes Act 2007 (ITA) section 535.

The exemption of OIGs is likewise conditional on their application to charitable purposes but, as the OIG generally represents a gain realised by the charity when it exits the fund, the availability of the charity exemption is not usually in doubt. The fact that a particular fund does not provide for annual distribution of income and/or capital returns does not prevent OIGs from qualifying for the exemption.

Essentially, the concerns of charity investors in offshore funds arising from the new regulations boil down to two aspects - (i) the taxation of undistributed fund gains and (ii) the taxation of undistributed fund income - and how these interact with the reliefs

for charities. The first issue arises under the existing legislation and is, unfortunately, preserved by the proposed regulations, whereas the second issue arises out of the specific provisions proposed in the draft regulations.

#### *Taxation of undistributed fund gains*

This issue arises because ICTA section 762 extends the scope of Taxation of Chargeable Gains Act 1992 (TCGA) section 13 to OIGs. Thus the issue arises only where the charity holds or is deemed to hold an interest greater than 10% in an offshore fund that is closely controlled. Nevertheless, this is not a purely theoretical concern, but an issue that arises in practice whenever a charity is considering a substantial investment in a fund that is marketed to a restricted circle of potential investors, or a fund in which the fund promoters/managers will be entitled to a significant interest. This is particularly likely to be the case where property funds or hedge funds are concerned (hedge funds are an acceptable asset class for charities with appropriate powers of investment), but it can apply to any category of fund with similar parameters, and the value of charity assets invested in such funds is steadily increasing year by year.

What this means in practice is that, where one offshore fund invests in another offshore fund, the current regime can apply in certain circumstances to gains realised by the first fund on disposing of its interest in the second fund. These circumstances arise where the first fund is closely controlled and holds a relevant interest in a non-distributing fund (NDF), as will commonly be the case with any NDF operating a master fund/feeder fund structure. If a UK resident investor has an interest of over 10% of the first fund, it can be taxed on its share of the first fund's OIG, whether or not the investor has realised its interest in the fund. Where the UK investor is a charity, HMRC currently take the view that the charity's share of the OIG cannot be applied to charitable purposes because it is a notional gain and does not, therefore, qualify for the charity exemption.

In our view, it is anomalous that the current rules tax a charity on its share of a closely controlled fund's OIGs regardless of whether the charity has realised any value from its investment. Under the proposed regulations, the effect of ICTA section 762 - and therefore the anomalous treatment of charity investors - is preserved by regulation 3.2.7. We suggest that it is illogical from a policy perspective to tax charities on gains that they have not realised because they cannot be applied to charitable purposes, while exempting them from gains that are realised because they can be charitably applied, when it is clear that the charity does not obtain any tax advantage by investing in the fund.

Therefore, we believe that it is appropriate to exempt charity investors from the section 762 charge on OIGs. To be consistent with the scope of the charity reliefs, the exemption could be made conditional on the application to charitable purposes of the proceeds of the charity's disinvestment from the fund. This would also be consistent with the Government's stated aims of removing UK tax barriers to multi-tiered fund structures and achieving economic parity with the position of UK investors in UK authorised funds (paragraph 1.5 of "Offshore funds: a discussion paper" published in October 2007). So far as we are aware, the Government rarely collects any tax from charities under ICTA section 762 and, consequently, we do not believe that such an exemption would result in a significant loss of tax revenue to the Exchequer.

*Taxation of undistributed fund income*

Industry reports suggest that it is likely that the removal of the distribution requirement will result in more funds seeking reporting fund (RF) status and being marketed in the UK. The proposals for taxing investment in RFs pose new problems for charity investors, in that they will be required to report for tax purposes each year their share of the RF's undistributed income (regulations 4.7.2. and 4.7.3). As the income is undistributed, it cannot be applied to charitable purposes and would, therefore, not qualify for the charity exemption of investment income (ITA section 532 and ICTA section 505(1)(c)).

We also note that HMRC have yet to decide how to tax distributions in excess of reported income (regulation 4.7.5). We would be concerned about any proposal that involves assessing investors on a notional sum that cannot be applied to charitable purposes for the same reasons as noted above.

*Offshore bond funds*

As regards offshore bond funds, it now appears from the comments in your e-mail that draft regulation 4.10.1 will be amended to preserve the current position, so that the loan relationship rules will continue to apply where a corporate investor has a relevant interest in an offshore bond fund whether it is a non-reporting fund (NRF) or not. This will essentially be on all fours with the treatment of an investor in an onshore unit trust bond fund.

In either case, however, there remains the risk, under both the existing and the proposed new rules, that a corporate charity investor (as the loan relationship rules can apply only to corporate charities) will be taxed on its share of undistributed bond fund income. In principle, a corporate charity is exempt from a charge under the loan relationships regime (by virtue of ICTA section 505 (1)(c)), but the exemption is restricted to the extent that the tax charge under the loan relationships rules is based on an unrealised increase in the value of the fund which cannot be applied to charitable purposes.

Although it is possible to take the view that this is a feature of the loan relationship rules rather than the offshore funds regime, it seems that the new regime does not clearly meet the Government's stated aims while it maintains this very narrow focus, which disregards the real effect on a particular class of investors. We suggest that these draft regulations are taken as an opportunity to clarify the position with regard to all charities, whatever their legal status.

*Compliance*

The proposed reporting fund regime also raises compliance issues.

Charity investors are required to report their income and capital gains on their annual tax returns whether they are exempt or not. The compliance costs for investors of reporting under the current regime are not generally significant, in so far as it is easy to identify offshore fund distributions and sales of interests in offshore funds.

The draft regulations make it clear that the burden of reporting under the new regime lies mainly with the RF itself, but clearly contemplate that some RFs may fail to meet their obligations in a timely manner. However, the draft regulations do not appear to change the reporting obligations of the investor and the potential penalties on the investor for inaccurate reporting if the RF fails to meet its obligations.

HMRC have not explained their approach to the imposition of penalties in these circumstances, yet it is clearly a matter of concern to all investors in RFs.

### *Conclusion*

We are pleased that you say that you are going to discuss these issues with your colleagues in CAR (Charities), but are a little surprised that you did not do so before the proposed regulations were published. You will be aware, as we are, that it is much more difficult to change things once they have been published.

The charity sector in general, and the Charities Tax Group in particular, has for some time been pressing the Government to adopt a more joined-up approach to charity regulation and taxation. In this particular case, we do not think that the issue can be resolved by simply saying that, if there is an anomaly, it lies in the charity rules not the offshore funds regime. The design of the OIG charge and the scope of the charity exemption from that charge, originally set out in ICTA section 761 (6), are clearly part of the offshore funds regime. It is disappointing to find that HMRC's anti-avoidance specialists are not actively liaising with their colleagues to identify the effects of what are often widely drawn measures on all stakeholders. This reinforces our concern that anti-avoidance measures, particularly those without a motive test or clearance procedure, should be targeted at cases where avoidance really exists.

Yours sincerely

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Chairman, International Taxes Sub-Committee

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