

TAXREP 17/09

OFFSHORE FUNDS: FURTHER STEPS

Comments submitted on 19 February 2009 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to a paper published in December 2008 by HM Treasury.

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OFFSHORE FUNDS: FURTHER STEPS

INTRODUCTION

1. Reproduced below is the text of our submission on 19 February 2009 to HM Treasury in response to its request for comments on a paper issued in December 2008.
2. The paper set out further steps in the reform of offshore funds taxation and included draft regulations on the modernisation of the regime for further consultation. It also set out the Government's proposals for a new definition of an offshore fund.
3. The Government sought stakeholders' views on the proposals and in particular, the Government welcomed views as to whether the draft legislation would deliver the policy intention set out in this paper.
4. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex 1. Our Ten Tenets for a Better Tax System which we use as a benchmark are summarised in Annex 2.

TEXT OF THE SUBMISSION

5. We appreciate that there has been significant consultation with respect to the proposed changes to modernise the offshore funds tax regime and welcome the fact that simplifying the system and providing certainty to UK investors and to the funds are two of the objectives behind this modernisation.

Executive summary

6. Our comments are confined to specific areas of the consultation document. We note there is ongoing discussion with product providers and hope that between now and the Finance Bill meaningful consultation goes on and that appropriate adjustments and amendments are made.
7. We cover the following:
 - ***The new definition of offshore fund:***
Support for further consultation and a general comment that clarification should be within the legislation and not the guidance (unless it is given statutory authority).
 - ***Pension funds which invest in Non-Reporting Funds:***
There should be specific provisions to provide that pension funds which invest into Non-Reporting funds are exempt and that stating this in the guidance is insufficient.
 - ***Transitional provisions:***
Why is it not envisaged that there will be transitional provisions should the changes to the offshore fund regime mean that an entity moves from being a distributing fund to a non-reporting fund?

The Tax Faculty of the Institute of Chartered Accountants in England and Wales

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Offshore Funds: further steps

- ***Investors not being permitted to apply for reporting status for the fund:***
A UK resident investor should be able to apply for recognition of any particular investment vehicle as a Reporting Fund, where the fund managers have not so elected; furthermore the legislation should only require that the status of the fund be established for years in which the investor is a UK resident.
- ***Offshore income gains, the remittance basis and the anti-avoidance provisions with respect to offshore income gains held by offshore structures:***
The opportunity should be taken to thoroughly review the rules in this area and would suggest that a working party including members from HMRC and the professional bodies (potentially drawn from those with relevant knowledge and experience from the Finance Act 2008 Residence and Domicile Stakeholder Group) could work together to frame proposals which would clarify and simplify the rules.
At a minimum the current disapplication in this area of Chapter 5 of Part 5 of ITTOIA 2005 should continue.
- ***Application of s 10A TCGA 1992:***
There is a need for appropriate commencement provisions.

The new definition of 'offshore fund'

8. The new definition of 'offshore fund' for tax purposes is of vital importance and we supported the Government's decision last year to defer the legislation to allow for further consultation with product providers and other interested parties. In the consultation paper it states that 'the Government intends to provide as much certainty as possible about which arrangements fall within the characteristics by setting out the principles in legislation and HMRC detailed guidance'. Whilst not disputing that HMRC guidance can be of significant assistance unless it is given statutory authority it should not be a substitute for appropriately drafted legislation.
9. We appreciate that consultation goes on with respect to the definition and welcome the commitment given in the paper to providing appropriate transitional and grandfathering provisions.

Pension funds which invest in Non-Reporting Funds

10. Paragraph 3.8 of the consultation paper states:

The Government does not intend to include specific provisions to provide that pension funds which invest into Non-Reporting funds are exempt. HMRC guidance will make clear that if an offshore income gain arises from an investment held for the purpose of a registered pension scheme, it will be exempt from tax.

11. We do not see why specific provisions cannot be included in the legislation.

Transitional provisions

12. We do not see why it is not envisaged that there will be transitional provisions should the changes to the offshore fund regime mean that an entity moves from being a distributing fund to a non-reporting fund.

Investors not being permitted to apply for reporting status for the fund

13. We have set down our concerns in this area previously. To re-iterate as the regulations currently stand under the new regime the tax treatment for an investor in an offshore fund will be entirely governed by whether the fund managers have chosen to apply for Reporting status. We do not feel that it is fair that an investor might lose the benefit of the 18% CGT rate merely perhaps because of actions or simple oversight by a fund management house. The issue is even more acute for individuals who have made the investment before coming to the UK. For example, as proposed currently, a UK resident with an investment in a US domestic mutual fund acquired while overseas will be subject to income tax on any surplus on disposal even if the mutual fund actually distributes all its income.
14. The proposed legislation, like the existing provisions, ignores the position of those who have made their investment while overseas, and also ignore the growth of enthusiasm on the part of UK residents about funds based in places other than the Channel Islands, the Isle of Man and such UK-oriented territories. Those funds ignored include those in other member states of the EU, who also may not be minded to incur the cost of establishing and maintaining themselves as Reporting Funds with the UK HMRC. In connection with this, we recommend that regard be had to whether any proposed differences in the treatment of funds based in other EU Member States from those based in the UK offend against any EU Treaty obligations, for example covering freedom of establishment.
15. This legislation thus presents considerable difficulties for many tens of thousands of non-UK nationals living in the UK and holding investments acquired before arriving in the UK, as well as British nationals returning to the UK holding investments purchased whilst abroad. The effects of this problem will be significantly increased because large numbers of foreign domiciled UK residents may opt to be taxed on the default arising basis as a result of the Finance Act 2008 changes in the remittance basis of taxation.
16. The solution is to enable the UK resident investor to be able to apply for recognition of any particular investment vehicle as a Reporting Fund, where the fund managers have not so elected. Furthermore, the legislation should only require that the status of the fund be established for years in which the investor is a UK resident. More radically, there could be an option of an annual income tax on an assumed distribution equivalent to say the official interest rate, with the amount brought into charge constituting allowable expenditure for eventual capital gains tax.

Offshore income gains, the remittance basis and the anti-avoidance provisions with respect to offshore income gains held by offshore structures

17. The taxation of offshore gains within offshore structures is acknowledged as one of the most complex areas within what is a highly complex anti-avoidance legislation. When issues with respect to foreign domiciliaries are considered the complexity increases further. It was mooted at the time of Budget 2008 that the changes to the remittance basis of taxation and the offshore structure anti-avoidance provisions would provide an opportunity to simplify the regime such that it was at least clear which set of anti-avoidance provisions should apply. In the event there was not the time to achieve this objective and it was thought that the changes to the offshore trust regime would provide the opportunity to reflect and make appropriate changes to clarify and simplify the provisions. This has not happened. Not only has there been no simplification but, by providing in regulation 3.2.8A that Chapter 5 of Part 5 of ITTOIA 2005 can apply (currently these provisions are disapplied), another layer of complexity is added. This is particularly the case for foreign domiciliaries where the remittance basis provision in ITTOIA 2005 can work rather differently from the normal application of the principle.
18. We would suggest strongly that this opportunity is taken to thoroughly review the rules in this area and would suggest that a working party including members from HMRC and the professional bodies (potentially drawn from those with relevant knowledge and experience from the Finance Act 2008 Residence and Domicile Stakeholder Group) could work together to frame proposals which would clarify and simplify the rules. If this is not felt to be feasible then we would ask that at a minimum the current disapplication in this area of Chapter 5 of Part 5 of ITTOIA 2005 should continue.

Application of s 10A TCGA 1992

19. We understand the Government's reasons for making this change. This is a policy decision and we have no comments to make on the policy rationale. We do, however, feel that there should be appropriate commencement provisions. Taxpayers need to have certainty and so we do not feel that the legislation should apply to disposals made before the regulations come into force. That is, if Mr S left the UK in October 2006, to take up a four year posting abroad, disposed of his holding in the Phoenix Non-Distributor Fund in November 2007 and returns to the UK in November 2010, we do not feel that the offshore income gain should be taken into account under these new provisions. Whilst he returned to the UK after the provisions came into force he disposed of the asset prior to that date and so we feel had a legitimate expectation that there would be no UK tax charge with respect to the disposal.

LB/FH
19 February 2009

ANNEX 1

ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales (ICAEW) is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department for Business, Enterprise and Regulatory Reform through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.
3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter *TAXline* to more than 10,000 members of the ICAEW who pay an additional subscription.
4. To find out more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at taxfac@icaew.com or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

ANNEX 2

THE TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as **TAXGUIDE 4/99**; see <http://www.icaew.co.uk/index.cfm?route=128518>.