

# UK Reporting Fund Status

What you need to know

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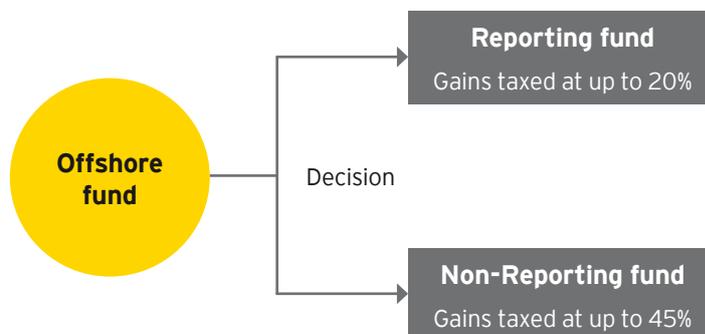
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## Introduction: 20% vs. 45% tax

UK individual investors in non-UK funds ('offshore funds') are taxable on their investment gains in two contrasting ways, at rates of either 20% or 45%.

The lower tax rate is only available to individual investors in funds which have elected into the UK's tax reporting regime, known as 'reporting fund status.' Institutional investors, including funds of funds, can also benefit when a fund has reporting fund status (see box on page 3).

Applying for reporting fund status is entirely optional, but can only be done by the fund manager or investment advisor. It has a profound impact on post-tax investment returns for UK investors. Non-reporting funds must outperform by more than 45% to overcome their tax inefficiency.



UK investors are left with a stark choice between investing in reporting and non-reporting funds. The UK tax authority, HM Revenue & Customs (HMRC), publishes a list of reporting funds, allowing UK investors to actively screen out non-reporting funds when selecting investments. Managers of non-reporting funds will often have no idea that they are losing out on these potential investors. Conversely, UK investors unfamiliar with the rules may be facing substantially diminished post-tax gains compared to expectations.



## Rationale: what it achieves

A UK investor in a non-reporting fund must pay income tax on their realised gain at rates of up to 45%. The purpose of imposing income tax rates is to prevent UK investors from securing a tax advantage. Without this rule, an investor could accumulate income free of tax in an offshore fund and then claim capital gains tax treatment on a realisation.

However, in the case of a reporting fund, the gain on realisation is treated as a capital gain, taxable at a maximum rate of 20%. Unlike some other jurisdictions this favourable rate is available regardless of how long the investor held their shares in the fund and of how long the fund typically holds its investments.

In both cases above, tax arises on realisation of the fund shares or units, rather than realisation of the underlying investments (which is generally not a taxable event for a UK investor).

In order to qualify for this significant tax advantage, the UK reporting fund regime mandates a form of flow-through for income (but not for gains). Each year, a reporting fund must calculate its income per share, net of deductions, and 'report' this figure to investors. UK investors are subject to tax annually on this 'reported income' as if the amount had actually been paid out as a dividend and then reinvested into the fund.

For funds generating substantial capital returns, reporting fund status can be highly advantageous. The annual tax charge for investors is very often zero, because important fund expenses such as management and performance fees are tax deductible (Negative results are treated as zero). However, for reporting periods commencing on or after 1 April 2017, funds will no longer be able to deduct performance fees in calculating their UK investors' reportable income. As such, investors can achieve capital gains tax treatment on realisation with little or no annual taxation in the interim.

## Exceptions

It should be noted that the UK's offshore funds regime does not apply to funds structured as partnerships. We can advise separately on the investor reporting requirements for a partnership fund with UK tax resident investors. However, holding companies owned by a partnership fund could themselves be caught by the offshore fund rules.

Different rules apply to funds domiciled in the UK, although the offshore fund rules are intended overall to achieve parity between investors in UK and non-UK funds.

## What is involved?

Reporting fund status is a two-stage process:

### 1 One-off initial application to become a reporting fund

#### ► Initial application

The fund must become a reporting fund by filing a one-time application with HMRC.

The initial application must state which sub-funds and share classes are to become reporting funds. Every share class is treated as a separate fund for these purposes, and can elect independently. The application must enclose a copy of the offering documents or prospectus, and must include various technical details about how the fund intends to calculate its reportable income each year.

The application takes effect from the start of the fund's own fiscal/accounting year, and is retroactive to the start of the year in which it is filed. The filing deadline to claim reporting fund status for the current year is therefore the same as the fund's current year-end date. If the deadline is missed, there is no way to go back and claim reporting fund status for that year. If a fund or share class launches (i.e., accepts its first subscriptions) during the last three months of the year, the deadline is extended to three months from the launch date.

### 2 Annual calculation and reporting of income to investors and to HMRC

#### ► Annual compliance

Each year, within six months of the fund's year-end, the fund must compute its income per share and report it to investors and HMRC. A calculation is required for every share class which has reporting fund status. For funds issuing shares in series, a separate calculation may be required for every series. The calculation is based on the data presented in the fund's statement of operations or income statement, split out to a per-share-class basis. The information to be sent to HMRC includes a copy of the fund's audited financial statements, the computation of reportable income, a declaration of compliance from the fund, and a sample copy of the reports of income sent to investors. The reportable income is calculated on a per-share basis and is therefore the same for all investors in a class (or series). No investor-specific information is sent to HMRC. The reports to investors commonly take the form of a letter, or may be posted on a website. There is no requirement to make the reports publicly available, though they typically provide no sensitive detail on the fund's underlying performance anyway.

## Investor treatment: realisation

A UK investor may refer to the published list on the HMRC website (see <https://www.gov.uk/government/publications/offshore-funds-list-of-reporting-funds>) to determine whether an offshore fund has reporting fund status, and the commencement date.

When a UK investor sells or redeems shares in an offshore fund which has not continually had reporting fund status throughout their holding period, the gain is taxable as income.

If the shares have had reporting fund status continually throughout the investor's holding period, the investor may claim capital gains tax treatment on the gain in their tax return.

Special rules apply to existing investors when a fund becomes a reporting fund for the first time. These rules allow the investor to benefit from reporting fund status prospectively, even though they acquired their shares at a time when the fund was not yet a reporting fund. These investors can make an election in their tax return to crystallise any unrealised gain (which is taxed immediately as income). Provided they do so, their investments in the fund are treated as separate holdings before and after the change of status, so that their ongoing investment is not tainted by the prior non-reporting period. No actual redemption and reinvestment is required.

This election is available to each investor individually. Investors who do not make the election will not benefit from capital gains tax rates on ultimate disposal of their investment, but will still be subject to income tax on any reported income in the interim. In the event that an investor's holding is standing at a loss on the date of conversion to a reporting fund, no such election is necessary or available, and the investor is treated as though the shares had always had reporting fund status.

## Investor treatment: investment lifetime

Investors holding shares in a reporting fund will receive a report of income from the fund every year. This report will state the income of the fund per share for the year just ended. Any UK investor who held shares in the fund on the last day of the year must pay tax as though the fund had actually distributed that income to investors as a dividend. The income is deemed to be received on the date six months after the year-end (even if the investor has sold his shares in the meantime). Special rules apply to prevent an investor from avoiding this reported income by selling shares and buying back either side of the year-end date.

The tax charge is a 'dry' or unfunded tax charge, in the sense that the investor may receive no actual dividend out of which to pay the tax. The amount of tax is frequently very small in comparison to the size of the investment, and is often zero, although this may not be the case where a fund holds high yielding assets or for fee-free share classes.

It should be noted that any actual dividends paid by offshore funds are taxed as income regardless of whether the fund has reporting fund status or not. If a reporting fund chooses to pay a dividend to investors, the dividend is taken into account to reduce the reported income of the fund for the year.

Just like an actual dividend from a fund, reported income is treated for UK investor tax purposes as either a dividend or an interest receipt depending on the investments held by the fund, with dividends attracting a slightly lower rate.



## Institutional investors

Institutional investors may also benefit from reporting fund status, depending on their own tax profile.

**Nominees and private banks:** The UK rules look through nominee and omnibus arrangements to the ultimate investor. If the end investors are UK individuals, even if their names do not appear on the shareholder register, then the UK reporting fund regime will apply to them just like any other UK investor. Optional special rules apply to investors through Swiss banks, but reporting fund status remains beneficial.

**Funds of funds:** A fund of funds with reporting fund status will prefer to invest exclusively in other reporting funds, since investments into non-reporting funds can create an annual tax liability for their investors. Gains on investment into a reporting fund are treated as capital, except to the extent that any reportable income is generated.

**UK pension funds:** Pension funds are generally exempt from taxation in the UK and therefore do not need to select investments based on reporting fund status.

**UK companies:** UK companies pay the same rate of tax on income and gains, but nevertheless benefit from a tax-free uplift on reporting fund holdings equal to the UK's Retail Price Index of inflation. Companies are also likely to be exempt from tax on any reported income, thereby obtaining a further tax-free uplift each year. Companies invested in funds which primarily hold debt securities are subject to a special tax treatment, and reporting fund status is irrelevant in this case.

## What next?

EY has extensive experience in reporting fund status. We have been closely involved in the development of the regime and continue to consult closely with HMRC on current issues and industry concerns.

EY can assist you in assessing whether reporting fund status would be suitable for your funds, filing initial applications to become a reporting fund, and completing the annual computation and reporting of income.

In more complex cases, we can analyse the treatment of interest bearing securities and derivatives where the reporting fund rules require a different treatment than that in the financial statements, or consult on whether the fund's activities might be considered 'trading' (specifically, trading as understood from a UK tax perspective), which would have an impact on the value of reporting fund status.

We can also advise on fund mergers, reorganisations and rationalisations, the establishment of new sub-funds and share classes, and any exposures of the fund to local taxes in the jurisdictions in which it acquires securities.

We would be delighted to discuss any of these with you in more detail. Please just contact one of the names on the front page.

## European investor reporting

You may be interested to know that comparable European reporting regimes exist in a number of countries, including Germany, Switzerland and Austria, and we are part of a wider team which provides European fund tax reporting services to clients across jurisdictions. We also have a dedicated group of US tax professionals/seasoned embedded in the team, who can provide K-1 and PFIC reporting services for US investors. Please let us know if you would like to know more.

## UK investor reporting for limited partnerships

UK reporting fund status is not available to funds structured as partnerships. Instead, UK investors in such a fund require detailed information on their attribution of the taxable activities of the partnership. The UK prescribes no standard format for the provision of this information (unlike, for example, Form K-1 in the US).

The unusual fiscal year for UK individuals (which ends on 5 April), together with differences in tax treatments between jurisdictions, means that investor statements prepared for another country could result in UK investors filing incorrect tax returns.

We can advise on the reporting required for UK investors in a limited partnership, and prepare investor statements in a suitable form for UK tax purposes. Please contact us if you would like to find out more.

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