UK Reporting Fund Status

What you need to know

Asset management tax

The better the question. The better the answer.
The better the world works.

Shape the future
with confidence

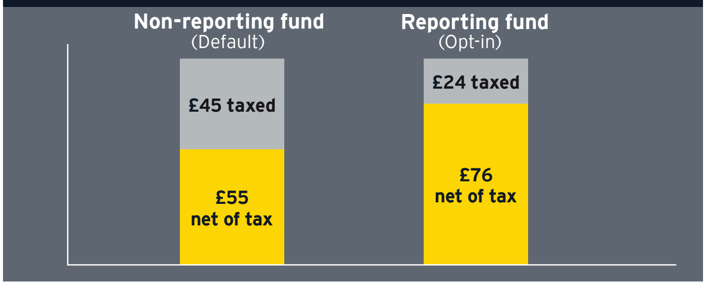
Introduction: 24% vs. 45% tax

UK individual investors in non-UK funds (offshore funds) are taxable on their investment gains in two contrasting ways, at rates of either 24% 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 UK Reporting Fund Status (UK RFS). Institutional investors, including funds of funds, can also benefit when a fund has reporting fund status (see box on opposite page).

Applying for reporting fund status is entirely optional, and 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 nearly 40% to overcome their tax inefficiency.

Net-of-tax returns on a £100 gain from an offshore fund



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 may not even realise that they are losing out on these potential investors. Conversely, UK investors unfamiliar with the rules may face unexpected tax charges on redemption.

* A higher rate of 48% applies in Scotland. This applies anywhere we refer to a 45% tax rate.

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 accumulating income free of tax in an offshore fund, and then claiming capital gains tax treatment on a realisation.

However, in the case of a reporting fund, the gain on realisation is respected as a capital gain, taxable at a maximum rate of 24%. Unlike some other jurisdictions this favourable rate is available regardless of how long the investor held their shares in the fund or how long the fund typically holds its investments.

In both reporting funds and non-reporting funds, 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 annual taxation for investors on their share of a fund's income (but not gains). Each year, a reporting fund must calculate its income per share, net of expenses, and reduced by the amount of dividends actually paid to investors. The fund must "report" this figure to UK investors, who must pay tax annually on this "excess reported income" as though 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 often zero, because important fund expenses, such as management fees, are tax deductible (negative results are treated as zero). A major exception to this rule is performance fees or other incentive-type arrangements which are not deductible, but which nevertheless reduce the eventual taxable gain.

Based on the above, investors can achieve capital gains tax treatment on realisation with little or no annual taxation in the interim.

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 financial 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 year-end date. If the deadline is missed, there is no way to go back and claim reporting fund status for the prior 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 is usually required for every series. The calculation is based on the P&L presented in the fund's financial statements, 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 particular election is available to each investor individually. Investors who do not make the election will not benefit from capital gains tax rates on eventual 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 their 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 might 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 for a fund holding 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 whether the fund has reporting fund status or not. If a reporting fund chooses to pay a dividend to investors, the income to be reported to investors is reduced accordingly.

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 tax rate.

Exceptions

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.

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

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.

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 are likely to benefit from a tax exemption on any reported income, thereby potentially obtaining a 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?

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

We 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" 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 contact one of the names on the back page.

Contacts

Alex Seeley
Partner
Ernst & Young LLP
T: + 44 20 7951 6096
E: aseeley@uk.ey.com

Keith Miller
Partner
Ernst & Young LLP
T: + 44 131 777 2227
E: kmiller@uk.ey.com

Diya Wilson
Partner
Ernst & Young LLP
T: + 91 20 7197 0808
E: diya.wilson@uk.ey.com

Rorie Jones
Director
Ernst & Young LLP
T: + 44 13 1240 2503
E: rjones16@uk.ey.com

Rebecca Benbow
Director
Ernst & Young LLP
T: + 44 13 1777 2326
E: rbenbow@uk.ey.com

Keshava Murthy
Director
Ernst & Young LLP
T: + 44 20 7783 0096
E: kmurthy1@uk.ey.com

Jacob Daniel
Senior Manager
Ernst & Young LLP
T: + 91 80 6681 3469
E: jacob.daniel@gds.ey.com

European investor reporting

You may be interested to know that comparable European reporting regimes exist in a number of countries, including 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 embedded in the team, who can provide K-1 and PFIC reporting services for US investors. Please contact us if you would like to find out more.

UK investor reporting for limited partnerships

UK reporting fund status is not available to funds structured as partnerships. This typically includes private equity, real estate, private credit and infrastructure funds. Instead, UK investors in such funds require detailed information on their allocation of the taxable activities within the partnership.

Although the UK prescribes no standard format for the provision of this information (unlike, for example, Schedule K-1 in the US), there are a number of ways that it is typically presented. If a fund does not provide this UK-specific detail to investors, the investors are at risk of filing incorrect tax returns, which will have potential penalty implications for the investors and a reputational risk for the fund.

English and Scottish limited partnerships will already have to do much of this work as part of their annual partnership tax return obligation. However, partnerships established outside the UK will need to prepare tax reporting information for investors, following UK tax rules. The unusual fiscal year for UK individuals (which ends on 5 April), together with differences in tax treatments between jurisdictions and even the effects of FX on investments, means that a UK investor cannot simply use tax reporting prepared for some other jurisdiction.

We regularly 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.

EYG no. 007216-25Gbl

UKC-040990.indd (UK) 10/25. Artwork by Creative UK.

ED None