

2 February 2010

Zoe Hart  
Assets, Savings and Wealth Team  
Her Majesty's Treasury  
1 Horseguards Road  
London  
SW1A 2HQ

Dear Zoe

### **Draft Tax Regulations for Funds Investing in Non-Reporting Funds**

As you know, the IMA represents the UK-based investment management industry. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of over £3 trillion of funds (based in the UK, Europe and elsewhere), including Authorised Investment Funds (AIFs), institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK AIFs (i.e. Authorised Unit Trusts and Open-Ended Investment Companies) and are the appointed investment managers of funds domiciled offshore, including non-UK UCITS.

We welcome the announcement of the tax regulations for Funds Investing in Non-Reporting Funds (FINROF) and note that they will apply to all types of AIF, whether UCITS, NURS or QIS, and whether equity funds, bond funds, TEFs or PAIFs. We also welcome the option to elect to be treated as a FINROF. We are aware that some existing AIFs would be interested in so doing.

We welcome the statement on HM Treasury's website that:

*"The Government will continue to work with industry on the issue of mixed funds and intends to consider further development of the regulations following their initial introduction."*

IMA would wish to be fully involved in these considerations.

However, we request that these draft regulations remain a permanent feature of the regime and a Government statement is made to this effect. Managers and investors will want certainty that these rules will remain in place when a fund joins this regime, irrespective of future rules coming into force. For many investors, the current proposals will continue to be acceptable. It is a form of "rough justice", in that all

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gains from the FINROF will be taxed as income, but for many investors this will not matter (e.g. pension funds, charities, CTF/ISA/SIPP investors). Therefore IMA requests that entry into any proposed tax rules to accommodate mixed funds should be optional.

We note that a number of draft regulations have appropriately used the wording from the offshore funds regulations. IMA requests that a watching brief is maintained by HMT/HMRC that where an amendment is made to either of these regulations, the same amendment is made to the other.

We provide detailed comments on the regulations in the attached. One of these comments relates to the definition of income property for the purposes of the FSA rules, so I am copying this letter to John Everett.

Should you require clarification on any of the points raised in this letter, please contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'S Lynam', with a stylized flourish at the end.

Steve Lynam  
Head of Tax

Copy to John Everett, FSA

## **Funds Investing in Non-Reporting Offshore Funds IMA's response to the Draft Regulations**

Our comments below are based on the order of the draft regulations.

### ***Regulation 85B – Interpretation***

The term "legal owner" is used throughout the FINROF regulations, but this is not defined in regulation 85B so we assume that it is the definition in regulation 6 (1) (SI 2006/964) which will apply. We are however unclear as to why this term has been used. The word owner usually applies to the legal and/or beneficial owner of fund units/shares. These regulations should refer to the Authorised Fund Manager or fund operator. (Note that the PAIF and TEF regulations refer to a manager or proposed manager of an authorised investment fund throughout.) In our subsequent comments below we refer to "manager" rather than "legal owner".

### ***Regulation 85E – Excluded Interests***

#### ***a) Deemed reporting fund status for non-reporting funds***

We note that there is currently no provision that would allow a UK manager to deem an NROF to be an equivalent reporting offshore fund if the manager has access to the appropriate information. Such a provision would give more flexibility in the regime, especially in the case where a fund are close to the 20% threshold but do not wish to be a FINROF.

Such a provision is currently permitted for reporting offshore funds under regulation 69 of SI 2009/3001 (Offshore Funds Regulations). We request that consideration is given to introducing an equivalent provision for UK investor funds under both the FINROF regime and the offshore funds regime.

We do not believe that an amendment to the SORP would be needed or appropriate. The SORP deals with the allocation of investment returns between revenue and capital in accordance with accounting principles. The retained investment return from an NROF is a capital return, notwithstanding any subsequent treatment for tax purposes.

We accept, however, that an amendment to the FSA definition of income property would be required. Such an amendment would need to permit a transfer between the income and capital accounts of the UK fund equivalent to the amount of reportable income for the NROF, computed by the UK fund where it has sufficient information available to perform such a calculation. We suggest this would be a fairly straightforward amendment. It would, of course, need to be consulted on and **we ask that this be done as soon as possible with a view to the additional provision in the FINROF regulations being able to take effect by the summer.**

#### ***b) Non-reporting offshore bond funds***

Regulation 85D states that an AIF meets the investment condition at any time at which it invests more than 20% of the value of the fund's gross assets in NROFs or

in other FINROFs. Regulation 85E provides a carve-out only for interests in transparent funds.

Therefore, under the current wording of the regulations, this would result in an offshore bond fund (s.490 CTA 2009) being treated as an NROF for investment condition purposes. This would appear to be a perverse outcome, as an AIF would annually mark-to-market its investment in the offshore bond fund and tax its investment return accordingly. There would be no benefit to UK corporate holders for an offshore bond fund to have reporting fund status.

**We therefore request that an offshore fund that is treated as a creditor relationship (s.490 CTA 2009) should be an excluded interest under regulation 85E.**

### ***Regulations 85F, 85G & 85Z10 – Regulatory Approval***

Given that an existing fund that elects to join or leave the FINROF regime would represent a fundamental change in the taxation position of UK investors, this is likely to be a significant event for regulatory purposes. We suggest that appropriate wording is included in the FINROF regulations, which recognises that regulatory approval might be required and makes it a condition that any necessary regulatory approval has been given before a valid election can be made.

There is a parallel provision already in the context of the 'Tax-Elected Funds Regime' (SI 2006/964, regulation 69Z49) where it says:

*"(2) Before making an application in relation to an existing authorised investment fund, the fund must obtain any necessary regulatory approval in respect of the instrument constituting the fund and the prospectus.*

*(3) The manager or applicant must notify HM Revenue and Customs when any necessary authorisation has been given."*

### ***Regulation 85J – Inadvertent fulfilment of investment condition***

#### ***a. Paragraph (3) (a) - Participant notification***

Where an inadvertent breach is encountered by a fund manager (e.g. due to falling values in other assets), the draft FINROF regulations state that it is a requirement to notify both the Commissioners of HMRC and the participants in the fund "as soon as possible". Where a manager has agreed with HMRC to divest investments in NROFs so as to ensure the fund falls below the 20% threshold, and that is accepted by the Commissioners, the fund is treated as if it had never breached the threshold by investors. The result of this is that there would be no overall tax impact on investors. Given that it would cause confusion for investors to receive consecutive and conflicting information, and that it is costly for a manager to notify participants, **we request that this requirement to notify the participants in the fund is removed for inadvertent breaches where the breach is subsequently rectified.**

We are in any case unclear what Reg 85 J is intended to achieve. If HMRC did not agree that the breach was inadvertent, and the fund was forced to become a

FINROF, it is a requirement under regulation 85I to notify participants that the fund has joined the FINROF regime, so the requirement under 85J is unnecessary.

***b. Paragraph (3) (b) – 3 month divestment rule***

Given that some offshore funds deal only quarterly or six-monthly, a fund manager may need longer than 3 months to divest from the fund in order that the AIF falls below the 20% threshold test. Therefore, **we request that this test is extended to at least 4 months in order to provide enough flexibility to cope with this situation.**

We are unclear as to whether it is a requirement that the investment condition itself must not be met within three months, or whether it would be sufficient for the manager to demonstrate that it has taken all reasonable within the three month period steps to ensure that the fund will no longer satisfy the requirement. For investments in funds that have long notice periods for divestment, this might be an important point. **Guidance on this issue would be appreciated.**

***c. Paragraph (3) (d) – HMRC response***

In order to provide certainty for managers and investors, **HMRC should be required to respond to managers within an appropriate period.** We suggest that 28 days would be appropriate, given that this is the period in reg 85K (2) for managers to appeal against an HMRC decision not to give written notice.

***Regulation 85U – Charitable companies and charitable trusts***

We welcome regulation 85U, which confirms that a charitable investor will not be taxed on an income gain arising from a disposal in a FINROF. **We request that an equivalent provision is included in these regulations to confirm that an income gain is also non taxable for pension fund investors in a FINROF.**

***Regulation 8 – Transitional provisions – the second case***

**We request that the term “reasonably expected” with regard to an offshore investee fund successfully obtaining distributor status be clarified, perhaps in the supporting HMRC guidance.** We would hope that an AIF should be entitled to rely, for example, on a statement in an offshore fund’s literature that it had received distributor status in the past and intended to obtain it for future periods. Since not all funds make a clear statement to this effect in their literature, guidance from HMRC is requested as to what other evidence might allow an AIF to meet this test.