DechertOnPoint

May 2011 / Special Alert

A legal update from Dechert's International and Domestic Tax Group

Equalisation Opportunities

New regulations to amend the UK's tax regime for offshore funds will take effect on 27 May. Managers of offshore funds with UK reporting fund status should pay particularly close attention to the final provisions regarding income equalisation and the opportunities and obligations these provisions present.

The UK's new tax regime for offshore funds and the associated reporting fund rules which enable UK resident investors to obtain favourable capital gains tax rates have been in place since December 2009. In February 2011, draft regulations were published setting out a series of proposed amendments to improve the practical operation of the rules. The draft placed particular emphasis on changes to the rules on income equalisation with a view to eliminating the 'last man standing' issue which can currently arise where a reporting fund does not operate equalisation. Essentially, this could result in UK investors in the fund at the end of a reporting period being allocated a disproportionate amount of fund income for tax purposes which would be especially unwelcome for certain investors, such as UK individuals, who pay a higher rate of tax on income than capital gains. A detailed explanation of this issue and the draft proposals is set out in our article "Changes to Report" in the *Dechert Financial Services Quarterly Report* (March 2011), a copy of which can be found at http://www.dechert.com/library/Financial_Services_Report_03-11.pdf.

In summary, the draft regulations proposed that some form of income equalisation or income adjustment be mandatory for reporting funds. The aim of such equalisation or income adjustment was broadly to allocate fund income across investors in a fairer manner, taking into account incoming or outgoing investors. A series of alternatives were available, ranging from "full equalisation", through plain "equalisation" to "income adjustment" on the basis of either accounting income or reported income. The suggestion of four alternative approaches to equalisation was, perhaps unsurprisingly, criticized for over-complexity.

The bad news coming out of the final regulations is that, in addition to the original four alternatives, there is now a fifth alternative. The good news, however, is that the fifth alternative is very simple—do nothing. Unlike the original proposals, the final regulations do not impose a mandatory adjustment of reportable income. Instead, it will be possible to apply no equalisation or income adjustment and this additional flexibility and freedom is likely to be welcomed by many.

In the case of new reporting funds, managers must determine the method of equalisation (if any) the fund will apply. Relevant considerations will be the 'last man standing' risk in light of the fund's investment policy (and the risk it may be trading) against investor expectation and the administrative burden of operating an equalisation or income adjustment. The decision must be notified to HM Revenue & Customs as a part of the fund's initial reporting fund application.

For funds already within the reporting fund regime, managers have until 27 May 2012 to notify HM Revenue & Customs of the method of equalisation (if any) the fund will now apply. Importantly, a failure to make such a notification within this timeframe will deem the fund to have elected to make income adjustments on the basis of reported income. "Do nothing" is not the

Dechert LLP

default option. Perhaps counter intuitively, if the manager of a fund wants to do nothing as regards equalisation it must initially do something, and submit the notification to achieve this outcome.

The new equalisation provisions will be welcomed by many managers and investors as a means of eliminating one of the principal downsides of reporting fund status. Others, on the other hand, will be grateful that this now remains only an opportunity and not an ongoing additional obligation. That said, even those wishing to choose the do nothing option must make a positive decision in this regard and notify HM Revenue & Customs accordingly. Reporting funds may also need to consider whether their prospectuses and/or UK marketing materials require amendment to reflect the position from 27 May and any decision made in relation to equalisation or income adjustment.

The new regulations also contain various other tax changes as noted in our previous article. In particular, amendments have been made to the draft regulations to improve the exemption designed to prevent interests held in certain funds, predominately private equity funds, from falling within the scope of the offshore fund rules.

Please contact a member of the Dechert tax group for further advice in relation to these changes.

Practice group contacts

For more information, please contact one of the attorneys listed or the Dechert attorney with whom you regularly work. Visit us at www.dechert.com/tax.

If you would like to receive any of our other *DechertOnPoints*, please click here.

David Gubbay
London
+44 20 7184 7420
david.gubbay@dechert.com

Mark Stapleton
London
+44 20 7184 7591
mark.stapleton@dechert.com

Daniel Hawthorne
London
+44 20 7184 7327
daniel.hawthorne@dechert.com

www.dechert.com

Dechert internationally is a combination of limited liability partnerships and other entities registered in different jurisdictions. Dechert has more than 800 qualified lawyers and 700 staff members in its offices in Belgium, China, France, Germany, Hong Kong, Ireland, Luxembourg, Russia, the UK, and the US.

Dechert LLP is a limited liability partnership registered in England & Wales (Registered No. OC306029) and is regulated by the Solicitors Regulation Authority. The registered address is 160 Queen Victoria Street, London EC4V 4QQ, UK.

A list of names of the members of Dechert LLP (who are referred to as “partners”) is available for inspection at the above address. The partners are solicitors or registered foreign lawyers. The use of the term “partners” should not be construed as indicating that the members of Dechert LLP are carrying on business in partnership for the purpose of the Partnership Act 1890.

Dechert (Paris) LLP is a limited liability partnership registered in England and Wales (Registered No. OC332363), governed by the Solicitors Regulation Authority, and registered with the French Bar pursuant to Directive 98/5/CE. A list of the names of the members of Dechert (Paris) LLP (who are solicitors or registered foreign lawyers) is available for inspection at our Paris office at 32 rue de Monceau, 75008 Paris, France, and at our registered office at 160 Queen Victoria Street, London, EC4V 4QQ, UK.

Dechert in Hong Kong is a Hong Kong partnership regulated by the Law Society of Hong Kong.

This document is a basic summary of legal issues. It should not be relied upon as an authoritative statement of the law. You should obtain detailed legal advice before taking action. This publication, provided by Dechert LLP as a general informational service, may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome.

Dechert in Ireland is an Irish partnership regulated by the Law Society of Ireland.

© 2011 Dechert LLP. Reproduction of items from this document is permitted provided you clearly acknowledge Dechert LLP as the source.

EUROPE Brussels • Dublin • Los Angeles • London • Luxembourg • Moscow • Munich • Paris **U.S.** Austin • Boston • Charlotte • Hartford • New York • Orange County • Philadelphia Princeton • San Francisco • Silicon Valley • Washington, D.C • **ASIA** Beijing • Hong Kong