CUMMINGS PEPPERDINE AND LARKSTOKE ADVISORS ON THE UK REPORTING FUND STATUS REGIME

HOW TO INVEST IN A FUND WITH TAX EFFICIENCY

CUMMINGS PEPPERDINE

+44 7734 057 327
Green Park House, 15 Stratton Street,
London W1J 8LQ

www.cummingspepperdine.com

LARKSTOKE ADVISORS

+44 (0)208 142 3805
www.larkstoke-advisors.com

INTRODUCTION

Anyone who is setting up a fund will be faced with a range of issues to consider. As well as the Jurisdiction of the fund and the fund manager, and the regulatory considerations which come with those decisions, is the overriding issue of tax.

The good news is that correctly setting up a fund which takes investments from UK individual taxpayers can give you an edge over others in your field. This is via the UK's Reporting Fund Status Regime.

The simple explanation on how to do this is just to create a separate share class (or share classes / series) which only accept investments from UK taxpayers and let HMRC know all about it. But, as ever, there is an art to what might seem a simple route.

And in this note, we tell you about that art and how we can help you find the tax efficient solution for your fund which will give potential UK investors the tax benefits they would like to see.

Offshore funds with UK Reporting Fund Status are significantly more advantageous to UK investors over non reporting funds as Reporting Fund Status enables

UK investors to have their gains taxed at capital gains tax rates of up to 20% rather than income tax rates of up to 45%. This 25% differential can be a significant gain to UK individual taxpayers.

The aim of the offshore fund rules is to treat investors in UK and non-UK funds equally from a tax perspective. The UK Reporting Fund Status Regime is optional and, once entered into, determines how UK investors are taxed both annually and on their gains upon eventual disposal.

Non-UK funds that meet the definition of an offshore fund can apply to HMRC to obtain UK Reporting Fund Status (RFS) if they meet certain conditions. Status is granted when the fund makes a successful application for Reporting Fund Status for each share class that has UK investors. Thus, each share class is treated as if it were a fund and calculations are prepared at a share class level.

HM Revenue & Customs (HMRC) publish a list of reporting funds that helps UK investors screen out any non-reporting funds when making investment decisions.

INVESTORS

Law and regulation

The first port of call when considering investors is whether you will be able to sell your fund to them. This is a legal and regulatory matter.

The promotion of hedge funds is restricted by law and they may only be promoted to certain categories of investors as set out under relevant law; as a result they are generally directed at institutional investors, such as pension funds, and sophisticated high net worth individuals and, save with the exception of UCITS funds, are not available to the general public.

In the UK, there are two layers of legislation to consider. The first is the regulation needed for anyone who conducts a specified activity in relation to a specified investment and this is governed by domestic regulation. The second layer is the Alternative Investment Fund Managers Directive, as it has been on shored into the UK post-Brexit.

Tax efficiency and the reporting regime

Also crucial to the structure is how individual investors are taxed, in particular those who pay tax in the UK as they may be able to benefit from the Reporting Fund Status regime.

> The Offshore funds that have Reporting Fund Status are significantly more advantageous to UK investors than those funds which do not have the Status

The stark 25% tax differential between reporting and non-reporting funds for UK individual taxpayers makes funds with UK RFS highly beneficial.

This significant benefit greatly increases the marketability of a fund with Reporting Fund Status in the UK. Any investors who need to confirm a fund's Reporting Fund Status can check its name on a publicly available list that can be found on the "HMRC Reporting Fund Status List" on this link.

For an investor to benefit from Reporting Fund Status, the fund itself must be within the regime for the entire period the investor has held its investment.

Existing funds seeking Reporting Fund Status for the first time can still benefit if a UK individual tax paying investor chooses to elect to crystallise the gain to date, pay income tax and benefit from Reporting Fund Status going forward. Where there is no gain, no income tax is due on transition and the individual benefits as though their shares always had Reporting Fund Status.

Careful consideration is required before entering the regime as it may not be beneficial for all strategies, and we can advise on this. To expand, Reporting Fund Status may not be suitable for funds whose activities might be considered 'trading' (rather than investing) from a UK tax perspective. For example, a high frequency quantitative trading strategy may result in high levels of Excess

Reportable Income (ERI), which is explained below, meaning that Reporting Fund Status may not be beneficial.

The Reporting Fund Status regime taxes investors on any income arising in the fund on an annual basis and the capital growth of the fund upon disposal. A fund which has Reporting Fund Status must comply with a number of requirements on an annual basis as the following need to be prepared:

- A calculation of 'reportable income' to identify any ERI. This calculation is performed per share class or series that has Reporting Fund Status and is broadly a calculation of revenue income less revenue expenditure in the year. UK investors are then taxed on their share of any ERI arising. As most fees are typically revenue in nature for these purposes (except performance fees), calculations often result in nil ERI. Any dividend paid by the fund reduces the amount of ERI to be included in the investor's tax return.
- A report to investors stating the amount of ERI (even if there is nil ERI).
- A documentation pack which needs to be submitted to HMRC and this must include a copy of the reportable income calculation, the report to investors, a declaration of compliance by the fund and its audited financial statements.

The deadline to meet these requirements is six months from the fund's year end, albeit that there is no penalty unless the information is not provided within 10 months.

Those funds which have Reporting Fund Status and then invest in other offshore funds can benefit if the underlying fund has Reporting Fund Status as well. This is relevant to the fund's annual reporting requirements as it will have to include any ERI from the underlying fund in its own reportable income calculations. Where the underlying fund does not have Reporting Fund Status, the investor fund under most circumstances, will have to include the movement in value of the underlying fund in its own reportable income calculations, thus potentially leading to a larger taxable figure for investors.

SHARE CLASSES

All the shares in the same class must be treated equally, thus it is necessary to create different share classes to accommodate varying rights. These include the rights or characteristics which relate to the reporting regime and it is common for a fund which holds Reporting Fund Status to have a separate share class or series for UK investors. A share class which is established for UK based employees / partners of the management company may also be set up and benefit from Reporting Fund Status.

Funds may also issue units in 'series' on a monthly basis. Whilst a separate Reporting Fund Status application is not required for every series (i.e. an application is made at the share class level as noted below), annual calculations must be submitted to HMRC for each series.

Timing is important. An application for one or multiple share classes to have Reporting Fund Status must be made and submitted to HMRC before the financial year end for which Reporting Fund Status is sought. Where interest in a fund has been issued in the final three months of its year end, the application deadline is extended to three months from the date on which such interests were issued to investors.

Subsequently funds must undertake ongoing compliance and submit reports, calculations and supporting documentation to HMRC on an annual basis for each share class or series with Reporting Fund Status.

HOW WE CAN HELP

Cummings Pepperdine and Larkstoke Advisors can provide a holistic solution and support for funds and fund managers.

We can structure and establish the fund and the fund manager, putting in place all documents and advising on how to meet all FCA requirements.

We can help managers navigate the offshore funds legislation and determine whether it is beneficial to register the fund under the Reporting Fund Status Regime. This may require an initial assessment of whether the fund is investing or trading, to consider whether Reporting Fund Status is truly beneficial.

Where Reporting Fund Status is required, we can help register funds with HMRC by completing an application and considering the most suitable elections to be made, based on the specific requirements of the fund.

Both at the launch of the fund and on an on-going basis, we can liaise directly with administrators of the fund (where required) to prepare annual calculations to determine whether any ERI arises in the fund, and help with the preparation of the communications which are required to be circulated to investors. In addition, we can help with the on-going compliance requirements by preparing the annual Reporting Fund Status calculations and compiling and making the annual submission of documents to HMRC.

We can also communicate directly with HMRC on any questions they raise.

As with all legislation, changes occur. We help our clients monitor and prepare for the impact of any changes in fund legislation, FCA rules and tax legislation. And when the fund grows, we can advise on new share classes, conversions, mergers and general restructuring of funds.

FURTHER INFORMATION

To help our clients, we have published a number of other notes which inform readers about relevant issues. These can all be found on our respective websites at:
www.cummingspepperdine.com
www.larkstoke-advisors.com

Claire Cummings

Priya Mukherjee

Cummings Pepperdine is a leading advisor in crypto. We are one of a select few that advises a large and diverse global client base in the crypto space and the only to provide a complete crypto solution building on the three key areas of law, tax and FCA with legal underpinning at every point. In law, we have a team of qualified and regulated solicitors and a barrister who retains right of audience.

In tax, we have one of the only crypto tax advisors who is both a qualified solicitor and qualified chartered accountant. In regulation, our team comprises specialists in crypto compliance monitoring structures and governance oversight who are known to the FCA for the quality of their work.

The team is led by Claire Cummings, a leading solicitor specialising in crypto law and the current and evolving regulation. Claire is on the advisory boards of a crypto exchange and an NFT gaming guild and is also a member of the Global Digital Finance working group on stablecoins. Claire has also acted as compliance officer, MLRO and director of an FCA regulated fund manager and qualified under SIB to trade derivatives. As a leading expert in crypto, Claire is a sought after speaker and has published multiple articles on the legal and regulatory issues surrounding cryptocurrencies and the crypto eco-system. Claire is named at the Top 10 influencer in London for hedge funds (2&20, 2022) and is included in the CityWealth Crypto Top 100

Claire Cummings
claire.cummings@cummingspepperdine.com
+44 (0)20 7585 1406
www.cummingspepperdine.com

Founded in September 2018, **Larkstoke Advisors** is a boutique professional services firm focused on providing UK tax advice to asset managers. We provide technical expertise, drawing on in-house and industry experience working with some of the biggest names in the alternative asset management industry. We are a member firm of the Institute of Chartered Accountants in England and Wales (ICAEW) and a member of Alternative Investment Management Association (AIMA). Larkstoke has been shortlisted for not one but two awards in the Tolley's Taxation Awards 2022 in the categories for Best Independent Tax Consultancy and Best New Tax Practice.As a firm we believe passionately in maintaining open and transparent relationships with tax authorities, ensuring that everyone pays their fair share of tax based on the legislation in force.

Priya is a Chartered Accountant and a Chartered Tax Advisor with over thirteen years' experience advising clients in the asset management industry on UK tax matters. She joined Larkstoke in 2020 and has a wealth of experience supporting asset managers on advisory projects and compliance matters – including transfer pricing, tax investigations, reporting fund status and a variety of other tax issues. She also has a Masters degree in Economics from the University of Warwick and an undergraduate degree in Economics from the University of Delhi.

Priya Mukherjee (FCA, CTA) – Partner
Priya.Mukherjee@larkstoke-advisors.com
+44 (0)208 142 3805
www.larkstoke-advisors.com