UK Taxation of Reporting and Non-Reporting Funds

Reporting and Non-Reporting Funds are taxed differently in the UK so it is important for investors to understand the distinctions and the potential impact on UK tax liabilities. Broadly, a non-reporting fund is any offshore fund that does not have HMRC reporting fund status. Offshore fund administrators can apply to HMRC for reporting fund status provided certain criteria are satisfied. HMRC publish a list of funds that have reporting fund status on their website.

Investors who are considering offshore funds should seek UK tax advice to ensure that investment decisions do not inadvertently give rise to higher tax liabilities in the UK. This is particularly important for non-UK domiciled individuals who claim the remittance basis of taxation.

Where an individual holding offshore collective investment funds moves to the UK, UK tax advice should be sought at the earliest opportunity to determine whether changes should be made to the investor's portfolio to optimise his UK tax position once he has become UK resident.

Reporting Funds

A fund that has been approved by HMRC as a reporting fund is required to report to the investor and HMRC details of the income that has arisen within the fund, whether or not the income has been distributed.

A UK resident investor must declare the income (whether or not distributed) in their UK tax return for the year, and pay tax on that income at their marginal rate of income tax (up to 45%, or up to 38.1% for dividends). Gains arising on the disposal of units are subject to capital gains tax (CGT) at a top rate of 20%.

Non-domiciled individuals who claim the remittance basis are only liable to UK tax on foreign income or gains to the extent they are remitted to the UK, and therefore only need to report income and gains that have been remitted to the UK.

Verfides, 5th Floor, 86 Jermyn Street, St James', London, SW1Y 6AW T +44 (0) 20 7930 7111 F +44 (0) 20 7930 7444 E london@verfides.com W verfides.com
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Where the investor is a non-UK domiciled remittance basis user, reporting funds that accumulate income may be tax inefficient because the fund will be regarded as a ‘mixed fund’ (containing a mix of original capital, income and/or gains). This means that when units are sold, it is not possible to segregate the income from the original capital invested or from any gains that arise on the disposal of the units. If a remittance is made from the mixed fund to the UK, income is deemed to be remitted first, before gains and any clean capital, and will give rise to an income tax charge at rates of up to 45%.

For non-domiciled individuals, reporting funds that distribute the income are likely to be more tax efficient than accumulating funds, since income can be mandated directly to an overseas income account. Gains can then be realised and held in a separate account. This allows for segregation of the income and gains so that if funds are required in the UK, the taxpayer can choose to remit from the capital gains account in preference to the income account, since remittances of gains are charged to CGT at a top rate of 20%, compared to income tax of up to 45%.

Note that distributing units may not be available in all funds, particularly funds that allow access to a particular market or asset class.

Non-domiciled individuals resident in the UK should ensure that the fund does not invest in UK situs investments since income and gains arising on UK investments is subject to UK tax on the arising basis, and cannot benefit from the remittance basis.

Non-Reporting Funds

Non-Reporting funds have no obligation to report the accumulated income to HMRC. The investor will therefore be liable to UK tax only on income that has been distributed to him. Remittance basis taxpayers are only taxable on distributed income if it is remitted to the UK.

The disadvantage to non-reporting funds is that gains are regarded as ‘offshore income gains’ and are subject to income tax, at rates of up to 45%, rather than capital gains tax at up to 20%. This is to prevent investors accumulating income free of tax in an offshore fund and then claiming capital gains tax treatment on disposal of the units.

For this reason, non-reporting funds can be tax disadvantageous for non-domiciled taxpayers who intend to remit the income or disposal proceeds to the UK, since remittance of either the distributed income or the 'offshore income gain' will give rise to an income tax charge in the UK of up to 45%.

It may still be beneficial for the fund to distribute (rather than accumulate) the income, provided the income is mandated into a separate overseas income account so as not to taint an existing clean capital or capital gains account. This is because, should a loss be realised on the disposal of units, the proceeds can be remitted to the UK free of tax, since the income will have been segregated.

Becoming Deemed Domiciled in the UK

Non-UK domiciled individuals who become deemed domiciled in the UK (e.g. after 15 years of UK residence) no longer have the ability to claim the remittance basis of taxation. Such individuals should therefore seek advice on how becoming deemed domiciled will affect their UK tax liabilities on their offshore funds, and also their UK tax position in general.

Summary

Individuals who are considering investing in offshore funds should ensure they understand the UK tax implications before an investment decision is made. Non-domiciled individuals who are eligible to claim the remittance basis of taxation are likely to find that reporting funds are preferable to non-reporting funds, and distributing units preferable to accumulating units, although this will depend on the individual's precise circumstances, including how long they expect to stay in the UK, whether funds are required for UK expenditure, and the extent of clean capital the individual has.

Verfides can assist with all aspects of UK tax advice in relation to offshore funds, including UK inheritance tax implications. Verfides also specialises in advising individuals moving to the UK and non-UK domiciled individuals already resident in the UK. For further assistance and advice, please contact our tax team on 0207 930 7111.

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