

# FUNDS OF ALTERNATIVE INVESTMENT FUNDS: A TAX FRAMEWORK

## Background

**1.1** In March 2007, the FSA issued a consultation paper entitled 'Funds of Alternative Investment Funds'. The paper proposed greater investment freedom for UK fund managers. In particular, it proposed that Authorised Investment Funds (AIFs) constituted as non-UCITS Retail Schemes (NURS) should be permitted to invest up to 100% of their assets into unregulated schemes<sup>1</sup>.

**1.2** Paragraph 3.41 of the FSA's paper covered taxation. It noted that there were a number of difficult tax issues involved with the proposal to allow greater investment freedom for UK fund managers.

**1.3** Since the Funds of Alternative Investment Funds consultation paper was issued, the Government has been considering the tax position for AIFs investing into unregulated funds. The Government's aim is to change the way UK AIFs which invest in non-distributing offshore funds are taxed in order to facilitate the introduction of Funds of Alternative Investment Funds. The Government has worked closely with the FSA in developing this approach.

## New Framework

**1.4** Under the current offshore fund tax rules, a UK AIF investing in a non-distributing offshore fund<sup>2</sup> does not pay any tax during the holding of that investment if it doesn't receive any income. Instead, the UK AIF pays corporation tax as if the gain it makes when it disposes of that investment is an income return rather than a return on capital. This gain is termed an offshore income gain. The offshore income gain is not available for distribution to the AIF investors. UK investors are then liable to pay tax on any chargeable gain arising when they dispose of their AIF investment.

**1.5** In order to facilitate the new Fund of Alternative Investment Funds regulatory regime, this paper sets out a framework for a new tax regime for funds that invest into non-distributing funds. This framework broadly moves the point of taxation from the AIF to the investor. The investors therefore face broadly the same tax treatment as if they had held the investment in the offshore non-distributing fund directly.

**1.6** The framework's key structural features are as follows:

## Type of authorised investment fund

**1.7** AIFs constituted as either authorised unit trusts (AUT) or open-ended investment companies (OEIC) will be eligible for the new tax regime.

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<sup>1</sup> FSA publication CP07/6: Funds of Alternative Investment Funds (FAIFs) published March 2007

<sup>2</sup> 'Offshore funds: a discussion paper' was published at Pre-Budget Report 2007. This paper proposes that investments into what is described as 'Non-Reporting' Funds are to be treated in the same way as current investment into non-qualifying offshore funds.

## Elective regime

**1.8** The proposed regime will be elective. Both existing and newly established AIFs will notify HMRC of their election in advance to give certainty of tax treatment for them and their investors.

**1.9** Whether or not a fund will wish to elect will depend on its investor base and investment strategy.

## Point of taxation

**1.10** UK AIFs which have elected into the new tax regime will be exempt from tax on the offshore income gains arising under section 761 Income and Corporation Tax Act 1988. Investment into assets, other than non-distributing offshore funds, will continue to be treated in the usual manner within the AIF.

**1.11** This proposal moves the point of taxation from the AIF to the investors, with the result that the UK investors will face broadly the same tax treatment as they would have, had they owned the non-distributing offshore funds directly.

**1.12** Taxable AIF investors will pay income tax or corporation tax on their gain as income when they eventually dispose of their holding in the AIF rather than capital gains tax or corporation tax on chargeable gains. Exempt investors will, as now, pay no tax when they dispose of their holding in the AIF and will benefit from the exemption of the offshore income gain within the fund.

**1.13** The Government recognises that this treatment will be suitable for AIFs with a specific investment strategy of investment into non-distributing offshore funds rather than those AIFs that wish to hold a range of assets in both non-distributing offshore funds and other categories of investment assets. This issue was also recognised by those in the funds industry who made representations regarding FAIFs and taxation.

**1.14** In order to facilitate the take up of FAIFs, the Government has decided to proceed with the framework as set out in this document. The Government will continue to consider whether, and if so when, it would be possible to expand the new tax regime to enable mixed funds and more flexible investment strategies to be put in place.

## Level of non-distributing offshore fund assets

**1.15** There will be no minimum holding requirement of non-distributing offshore fund assets. The Government considers that the level held should be determined by the AIFs investment strategy and other commercial considerations.

## Transitional provisions for investors in existing funds

**1.16** The Government recognises that existing investment funds may wish to take advantage of this proposed new elective tax regime and that there will therefore be transitional issues.

**1.17** Government intends to align, as far as possible, the tax treatment of investors in this new tax regime with investment into offshore funds. HM Treasury issued a publication entitled 'Offshore funds: discussion paper' at PBR 2007 which addresses similar issues on which responses are currently being considered.

**1.18** The Government intends to provide detailed transitional rules at the earliest opportunity.

### **Next Steps**

**1.19** The Government intends to use this framework as a basis for further discussions with representatives from the asset management industry and the FSA. The Government intends to publish draft regulations during Spring 2008.

**1.20** If you have any questions about the framework or wish to put forward comments on the issues raised above please contact Sue Harper (+44 (0) 20 7270 6031) [sue.harper@hm-treasury.gov.uk](mailto:sue.harper@hm-treasury.gov.uk).