Little-known problem

Amit Puri looks at the (not-so-obvious) difficulty in the UK with Indian mutual funds.

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Our widespread network of bookkeepers, accountants and wealth managers consistently flag this common question: how are clients' mutual fund investments taxed in the UK? While this article will focus on investments made into Indian mutual funds, the principles apply to other mutual funds and non-UK/ offshore funds more generally too.

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Background

In an attempt to put the size of the mutual funds industry in India into context, we ascertained that the assets under management (AUM) held there crossed 30tn Indian rupees (INR) for the first time in November 2020. By 30 September 2021, the industry had increased to INR36.74tn; that is about £350bn!

These figures come from the Association of Mutual Funds in India, which is the official association of all the asset management companies of registered mutual funds in India, incorporated in 1995 as a non-profit organisation. At the time of writing, we understood all 45 registered companies were its members.

We also noted that the Indian mutual fund industry's AUM had grown from INR15.8tn on 30 September 2016, which is more than a two-fold increase, in a span of only five years. Plus, the total number of mutual fund accounts (or folios as they are referred to in India) stood at a huge 111.7m as of 30 September 2021. Folios are numbers designated to individual investor accounts, but an investor can have multiple folios.

By any stretch of the imagination, these are eye-watering numbers which, no doubt, continue to contribute to the exponential interest from investors around the world, and thus the booming funds industry in India (and internationally). This is in no small part due to the extensive groundwork done by mutual fund houses and Indian financial advisers, and the proliferation of technology, in educating and shepherding investors.

As someone with an Indian background, I am mindful there is a very clear migration from real estate and gold to such structured financial products. Historically, the South Asian community's goal was largely to invest in bricks and mortar.

Key points

- The mutual fund industry in India is sizeable.
- This has resulted in exponential interest from investors around the world, and thus the booming funds industry in India, as well as internationally.
- The 'offshore funds tax regime' applies to Indian mutual funds.
- HMRC's offshore reporting funds list does not feature any single Indian fund, so advisers may struggle to identify the type of offshore financial product their clients have for tax purposes.
- Approved 'reporting' offshore funds are taxed differently to unapproved 'non-reporting' offshore funds.

Relevant legislation

The 'offshore funds tax regime' applies to mutual funds. HMRC's *Investment Funds Manual* is a fair resource for more detailed information. It explains how UK-resident investors in offshore funds are treated for UK tax purposes, under the current regime, at part 8 of the TIOPA 2010 and the Offshore Funds (Tax) Regulations 2009.

The definition of an offshore fund is limited to 'mutual funds' so in effect they are the same for UK residents where they are resident in, or based in, a territory outside the UK. The statutory definition of the term 'mutual fund' is provided by TIOPA 2010, s 356.

It is drawn widely and encompasses any arrangements with respect to property of any description, including money, so it does not matter what the underlying investments are. Whether arrangements amount to a mutual fund depends on three conditions (conditions A to C), *all* of which must apply to the 'participants' of the arrangements that broadly have the characteristics of *pooled investments*.

Participants are the beneficial owners of interests in the arrangements or the property underlying the arrangements, whether or not they have legal ownership of their interests.

Condition A requires that the purpose or effect of the arrangements is to facilitate pooled investments which enable the participants to 'participate in the acquisition, holding, management or disposal of the property, or to receive profits or income from those transactions or sums paid out of such profits or income'.

Condition B is that the participants do not have day-to-day control of the management of the property.

Condition C requires that a 'reasonable investor' would, as a participant in the arrangements, expect to be able to realise all or part of an investment in the arrangements on a basis calculated entirely or almost entirely by reference to either:

- the net asset value (NAV) of the scheme property; or
- an index of any description.

'Realisation' of an investment has a wide meaning, and so it may be by redemption, by sale to a third party, or by distribution of assets on the termination of a fund. For example, if a fund has a limited life, it would not matter that an investor may not be able to sell their shares or units on the open market for a sum representing NAV or close to NAV, as there would be an expectation that the investment could be realised at or close to NAV when the fund terminated.

A 'reasonable investor' is not defined in the legislation. So it is assumed that such an investor (whether an individual, corporate investor, or otherwise) would have read the investment documentation and taken account of all additional material and communications of any nature whatsoever provided by the mutual fund before investing.

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Broadly, the mutual fund definition applies to a company (s 355(1)(a)), a trust (s 355(1)(b)) or any other vehicle or arrangement (s 355(1)(c)) that has the following characteristics:

- it is not UK tax-resident;
- it exists to enable participants to take part in the benefits arising from the acquisition, holding, managing, or disposing of assets of any description;
- the participants do not have day-to-day control of the management of the property, whether or not they have the right to be consulted or give directions; and
- a 'reasonable investor' would expect to be able to realise any investment based entirely or almost entirely by reference to

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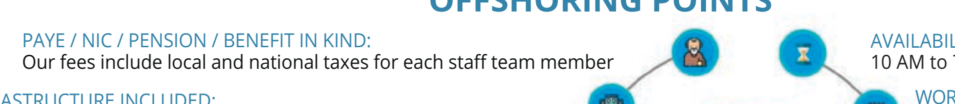

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the NAV of the assets under management or, alternatively, by reference to an index of any description.

There are some exceptions, but we will not cover them here because we rarely see them in practice.

View from the UK

Readers will appreciate that UK clients increasingly invest in Indian mutual funds with many having done so for some time already. This is whether as a result of their own research and active management of their financial investments or by being driven towards such offshore funds by their wealth managers in India. HMRC's offshore 'reporting funds' list is updated on a monthly basis. Interestingly, our understanding is that it does not feature a single Indian fund!

This is a list of offshore funds that have successfully applied to HMRC for 'reporting fund' status. The total number of identifiable sub-funds at the last count appeared to be about 88,000 (of which some 62,000 are still active), while the unique fund reference numbers suggested about 3,700 approved/reporting offshore funds.

Readers should note that Indian mutual funds are not on the list, and there are several hundred. This is where the UK taxation fun starts, and why so many advisers struggle to identify the type of offshore financial product their clients have.

So why have this list?

For the avoidance of doubt, approved 'reporting' offshore funds are taxed differently from unapproved 'non-reporting' offshore funds, and so the differentiation is important to grasp for annual tax compliance work and when preparing tax disclosures for clients regularising past errors in their personal tax returns.

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From our experience, advisers ought to be looking to identify some or most of the following:

- fund's name;
- any reporting fund reference;
- any previous distributing fund reference;
- any sub-fund reference;
- any international securities identification (ISI) number;
- any stock exchange daily official list (SEDOL) number; and
- any Committee on Uniform Securities Identification Procedures (CUSIP) number.

This information is usually found on the offshore financial product's prospectus, performance report and other records issued by the mutual fund to the investor or participator.

The existence of this information will help match it to HMRC's approved/reporting offshore funds list. If the offshore fund is not included though, then it will by default be an unapproved/non-reporting offshore fund.

By contrast though, where clients own their underlying financial assets themselves, which are usually identifiable from their shares and stocks records or on their statements for any portfolio investment accounts, they will likely not have an offshore fund. The emergence of this information will be consistent with the clients' direct and distinct holding or ownership of the investment, ie it will not be a 'pooled investment' and they will be able to exercise day-to-day control of the underlying investment's management. In these circumstances, the investor will be liable to UK income tax on items such as interest, coupons, or dividends and to capital gains tax on the disposal of financial assets such as shares and bonds as normal, subject to any double taxation relief.

Where does this leave us?

We are then left to consider the UK tax consequences of reporting and non-reporting offshore funds. To be clear, HMRC favours reporting funds, because the quality of the offshore fund's performance reporting meets higher standards. This enables investors to clearly identify gains and losses arising within the fund, and thus their own share of those results. It follows that the UK capital gains tax regime applies in these situations.

Conversely, in the case of non-reporting funds, HMRC does not consider the offshore fund's performance reporting to be adequate or the offshore fund has not applied to HMRC to successfully attain 'reporting' status. So, any losses arising from withdrawals or surrenders from those funds are still treated as capital losses, whereas the gains are liable to income tax instead. We do not cover the offshore income gains tax regime here further for the sake of brevity. Notably, the difference means that losses can only be used against capital gains, while any offshore income gains are taxed at much higher marginal income tax rates than those for capital gains tax.

In conclusion

This article is only a whistle-stop tour through offshore funds and mutual funds. UK investors and their trusted bookkeepers and accountants are thereby recommended to take appropriate specialist UK tax advice in this regard.

Readers should also note that investing in offshore funds brings many more complexities than just those highlighted here. For example, another problem which is becoming increasingly apparent, is the issue of a reporting offshore fund's inability to monitor undistributed income within the fund. This can lead to excess reporting income issues, which has and is causing HMRC to write to clients too – forcing tax disclosures to be made – not only where income and gains from offshore funds have not been declared in the UK. ●

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