

Offshore funds: a discussion paper

October 2007



HM TREASURY



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INTRODUCTION

1.1 The UK tax regime for offshore funds was introduced in 1984. Broadly, its purpose was to establish the tax treatment of activities that seek to use certain offshore funds to convert income flows into capital gains. Prior to its introduction, a UK investor could accumulate income in an offshore fund, and, when the investment was realised, be subject only to tax on capital gains rather than having to pay tax on income. In contrast a combination of regulatory and tax rules meant that UK investors had to pay tax annually on income from UK funds. The purpose of the regime remains the same.

1.2 The offshore funds tax regime charges realisations of an offshore fund investment to tax as income rather than as chargeable gains, unless the offshore fund is certified by HM Revenue and Customs (HMRC) as having ‘distributor status’. An offshore fund must meet certain conditions in order to obtain ‘distributor status’ including annually distributing at least 85 per cent of its income and not investing more than 5 per cent of assets in funds that do not themselves have distributor status.

1.3 The marketplace for funds has changed significantly since these rules were introduced. For example, in 1984 it was not possible to market unit trusts and open-ended investment companies from one European Union (EU) country to another. However, developments in the EU regulatory environment have opened up the market to cross-border selling, encouraging the development of pan-European retail products, for example UCITS¹ funds.

1.4 Further commercial and EU market developments have also produced an expansion in investment opportunities, including the increasing use of multi-tiered fund structures. In recognition of this, in October 2006 the Government announced that it would consult with industry to ensure that UK tax rules in the offshore funds regime do not act as a barrier to the commercial development of multi-tiered funds.

1.5 As stated in Budget 2007, one of the Government’s main objectives in proposing changes to the offshore funds tax regime is to remove UK tax barriers to multi-tiered fund structures. At the same time the Government aims to:

- simplify the operation of the offshore funds tax regime;
- provide more certainty to UK investors and funds;
- achieve, to the extent possible, economic parity with the position of UK investors in UK authorised funds, whilst recognising that the Government has no taxing rights over non-UK vehicles themselves;
- strengthen existing anti-avoidance rules so that UK investors who choose to invest into offshore funds do so based on commercial decisions and not to obtain unintended tax advantages;
- implement a modernised regime at no increase in cost to the UK Exchequer.

¹ Undertakings for Collective Investments into Transferable Securities

1.6 To date, the Government has held informal discussions with industry stakeholders to develop its proposals and would like to thank those representatives for their contributions. Further to those discussions, the Government is now in a position to issue this discussion paper setting out these proposals.

1.7 This discussion paper sets out how the Government intends to modernise the offshore funds rules and seeks views on these proposals. It covers changes to the definition of offshore funds for UK tax purposes, a proposed framework for offshore funds and the tax treatment of UK investors into those funds. An Impact Assessment is published within this discussion paper including specific questions on which the Government welcomes comments.

Summary of key features

1.8 The key features of the proposed modernisation to the offshore funds rules include:

- a new tax definition of an offshore fund based on characteristics rather than specific conditions;
- a facility for an advanced election to be a ‘Reporting Fund’, providing certainty to UK investors and fund managers;
- the ability to report deemed distributions to UK investors rather than the requirement to physically distribute;
- the consideration of only one ‘layer’ of funds for ‘Reporting Funds’. There are neither percentage investment restrictions nor a limit to the number of ‘layers’ into which a ‘Reporting Fund’ can invest; and
- treating investments into ‘Non-Reporting’ funds in the same way as under the current regime for investments into non-distributing funds.

2

DEFINITION OF 'OFFSHORE FUND' FOR TAX PURPOSES

2.1 This chapter sets out proposals for a new definition of an offshore fund for UK tax purposes. The aim is to simplify the current rules and give certainty to non-UK funds, their managers and investors.

2.2 The current tax definition of offshore fund is based upon the regulatory definition of 'collective investment scheme' as set out in the Financial Services and Markets Act 2000 (FSMA) with modifications for tax purposes. The Government proposes that the new definition for tax purposes should be detached from the regulatory definition.

2.3 The Government believes that any new offshore fund definition for tax purposes should be based on characteristics. The characteristics based approach aims to counter unintended tax advantages being obtained where an offshore arrangement is technically outside the current definition of an offshore fund but the arrangements are economically the same. The characteristics should be applied to a company, trust or any other vehicle or arrangement which:

- is created under foreign law;
- is not UK tax resident;
- is managed by a fund manager such that the investors do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or give directions;
- creates rights in the nature of co-ownership where the investors are not taxed directly on their share of the underlying income;
- has the purpose of investment of the co-owners' funds with the aim of spreading investment risk; and
- entitles investors to realise substantially the net asset value of its interest on realisation.

2.4 In short, it is a non-UK vehicle where investors 'pool' their money to collectively invest in various types of assets where those assets are not managed by the investors themselves.

2.5 The Government is aware that the change to the definition of an offshore fund, enacted in Finance Act 2007, caused some confusion for certain investment vehicles and, as a result, guidance was issued by HMRC. The Government welcomes product providers and other interested parties who might be concerned about the implications of the "entitlement to realise net asset value" characteristic discussing their concerns with HM Treasury in order to determine whether any special provisions might be required for existing vehicles.

Point 1 for discussion: The Government welcomes comments on the proposal to move to a characteristics based definition for an offshore fund for UK tax purposes. The Government invites comments on the proposed characteristics outlined in paragraph 2.3. The Government recognises that the reference to entitlement to 'realise substantially the net asset value' may raise questions for certain stakeholders and welcomes comments in this regard.

2.6 Under the current rules, section 756C Income and Corporation Taxes Act 1988 (ICTA 1988) states that a class of interest in an offshore fund (excluding umbrella funds – see paragraph 2.7) can be regarded as a separate offshore fund for the purpose of income attributable to that class. In order to meet the distribution requirements, some funds currently choose to issue a separate class of shares for UK investors. Since the proposed characteristics do not require physical distributions in order to obtain Reporting Fund status (see paragraphs 3.24 to 3.26), the current requirements of section 756C ICTA 1988 may not need to be replicated in the proposed regime for Reporting Funds to satisfy distribution requirements.

Point 2 for discussion: The Government welcomes views as to whether it is necessary to have a provision similar to section 756C ICTA 1988 within the proposed regime.

2.7 In line with the current tax rules, an 'Umbrella Fund' itself will not be treated as an offshore fund. However, each sub fund within an 'Umbrella Fund' structure will need to be considered to determine whether it falls within the new tax definition of an offshore fund in its own right. In addition, the application of the new offshore funds tax regime to an individual cell within a protected cell company will need to be determined on its own particular facts, identical to the current rules.

2.8 The Government recognises that the offshore funds tax definition must take into account different types of corporate and non-corporate, trust-based or purely contractual arrangements. The way in which these vehicles are considered for UK tax purposes and their respective UK investors differ.

Unit trust schemes

2.9 A unit trust scheme is defined in section 237 FSMA as 'a collective investment scheme under which the property is held on trust for the participants'. The definition of unit trust schemes for the purpose of the current offshore funds tax rules is based upon this definition with reference to specific exclusions in FSMA 2000 (Collective Investment Schemes) Order 2001 Statutory Instrument 2002/1062.

2.10 In order to avoid unnecessary complexities, the Government does not intend to have a separate tax definition of a 'unit trust scheme' for the offshore fund tax regime. Instead, a trust which has the characteristics set out in paragraph 2.3 should be considered an offshore fund for the purpose of the proposed regime. Unit trusts that are tax transparent for income will be excluded.

Point 3 for discussion: The Government welcomes views on the inclusion of any trust with the characteristics set out in paragraph 2.3 within the new offshore funds regime and particularly on whether, and if so why, such an approach would create uncertainty for offshore trust schemes.

Other contractual arrangements and tax transparent entities

2.11 Contractual arrangements, including partnerships, can constitute a collective investment scheme within the current definition in FSMA 2000. However, many contractual arrangements are tax transparent in respect of both income and capital gains for UK tax purposes.

2.12 The Government intends to exclude such arrangements from the new regime because they mean that UK investors are subject to current tax on the income and gains as they arise or are brought into account from investment in the arrangements. This mirrors the rules under the existing regime.

Non-tax transparent entities **2.13** The Government proposes that contractual arrangements, excluding unit trust schemes (described in paragraphs 2.9 and 2.10) which are neither considered to be bodies corporate nor considered to be transparent for UK tax purposes should, for the purpose of the proposed new regime, be treated as if they were an open-ended body corporate.

Bodies corporate **2.14** The Government proposes that an offshore vehicle that is constituted as a body corporate will be subject to the new offshore fund regime if it meets the criteria set out in paragraph 2.3. The definition is intended, in relation to bodies corporate, to capture the essence of an open-ended company arrangement. The Government recognises that some non-UK entities which might not be regarded as 'open-ended' for the purposes of section 236 FSMA 2000 may fall within the proposed definition of an offshore fund.

Other legislation relying on the definition of 'offshore fund' **2.15** Other parts of the UK tax legislation rely on the existing definition of offshore fund in section 756A ICTA 1988. These other legislative rules include:

- a holding in an offshore fund in an insurance company's long term business fund (section 212 Taxation of Chargeable Gains Act (TCGA) 1992);
- interests in offshore funds substantially invested in securities and other forms of debt (paragraph 4 Schedule 10 Finance Act 1996); and
- holdings that can constitute giftable securities for the purposes of section 587B of ICTA 1988 and section 432 Income Tax Act 2007.

2.16 The Government will consider whether other parts of the tax legislation should also incorporate the new definition of an offshore fund or whether they require bespoke definitions.

Point 4 for discussion: The Government welcomes comments on paragraphs 2.11 to 2.16.

3

PROPOSED FRAMEWORK FOR OFFSHORE FUNDS

3.1 This chapter outlines the framework for the proposed new regime from the fund's perspective.

Offshore fund status

3.2 Under the proposed tax regime for UK tax purposes, an offshore fund can elect to be a Reporting Fund. If it makes no election it is considered to be a Non-Reporting Fund.

3.3 The proposed tax regime for a Reporting Fund is broadly similar to that currently applying to a 'distributing fund' but with some notable differences including:

- replacing the requirement to distribute 85 per cent of income, as calculated in accordance with specific rules with the requirement to annually 'report' to the UK investor their share of the fund's income;
- introducing a new calculation of 'reportable income' as an alternative to the current UK Equivalent Profits (UKEP) calculation;
- modernising the rules concerning compliance; and
- abolishing the 5 per cent investment restriction test (discussed in Chapter 4).

3.4 The proposed Non-Reporting Fund is similar in concept to a fund that is not a distributing fund under the current regime.

Reporting Fund

3.5 In determining whether to elect into the Reporting Fund regime, it is envisaged that the offshore fund will consider many factors including its investor profile and the assets into which it invests.

3.6 The main proposed requirements (set out in detail in the following paragraphs) for a Reporting Fund are:

- i. obtaining HMRC approval to become a Reporting Fund;
- ii. disclosure of Reporting Fund status;
- iii. submitting to HMRC, on an annual basis, audited financial statements, prepared under International Accounting Standards (IAS), UK Generally Accepted Accounting Practice (GAAP) or an alternative GAAP;
- iv. introducing a computation of income based on financial statement figures representing the 'total return' with adjustments for the Statement of Recommended Practice (SORP) relating to Authorised Investment Funds issued by the Investment Management Association (IMA); and
- v. annual 'reporting' of income to UK, other Reporting Fund investors and HMRC.

Requirements (i) and (ii) **3.7** Under the current rules, in order to secure approval as a distributing fund, the fund must make an annual application to HMRC. Approval is only given retrospectively and must be applied for and obtained separately for each and every period of account for which it is required. The Government recognises that this creates uncertainty for funds and their UK investors.

3.8 Under the Government's proposal, an offshore fund can elect to be a Reporting Fund by applying for approval from HMRC in advance of the fund's first period in which it wishes to be a Reporting Fund. As part of the approval process, a fund will need to submit certain information, including the fund's prospectus or proposed prospectus. In addition, to avoid unintended tax advantages, it must be evident that the Reporting Fund has a genuine commercial purpose and that the main purpose, or one of the main purposes, of the fund is not the deferral or avoidance of UK taxation. HMRC intends to issue guidance in respect of genuine commercial purpose.

3.9 For its part, HMRC will review the fund's application for Reporting Fund status and will give clearance provided that the fund commits to fulfilling the requirements of the regime (listed in paragraph 3.6).

3.10 This process will provide certainty for fund managers when marketing the fund to UK investors as a Reporting Fund. Reporting Fund status will continue throughout the life of the fund unless it no longer wishes to be within the regime or no longer complies with the requirements.

3.11 It is envisaged that a Reporting Fund will disclose its status to its UK investors and other Reporting Funds that are investors. This means that those investors will have certainty that they will be treated, for UK tax purposes, as investing into a Reporting Fund.

Point 5 for discussion: The Government invites views on requirements (i) and (ii).

Requirement (iii) **3.12** In line with the current distributing fund rules, a Reporting Fund will be required to annually submit its audited financial statements to HMRC with a calculation of the adjustments undertaken to compute its reported income (as set out in paragraphs 3.14 to 3.23).

3.13 As for a distributing fund, the Government intends that these should be submitted within six months of the date to which it draws up its financial statements. The Reporting Fund will make a declaration, when submitting the relevant information to HMRC, confirming it has complied with the Reporting Fund requirements throughout the relevant period.

Point 6 for discussion: The Government seeks views on requirement (iii).

Requirement (iv) **3.14** Under the current offshore funds tax regime, distributing funds are required to calculate UK Equivalent Profits (UKEP) as well as their accounting income in order to determine the amount of income they must distribute to comply with the UK tax rules.

3.15 The Government understands that UKEP may be calculated solely for the purpose of compliance with the UK tax requirements and may be burdensome for some funds to calculate. The Government aims to align the calculation of income, as far as possible, with the requirements for UK authorised funds whilst ensuring that there is no

loss of tax to the UK Exchequer and that the distinction between ‘income’ and ‘capital’ is maintained.

3.16 The Government is currently exploring whether an alternative calculation could reduce the compliance burden for offshore funds in place of the UKEP calculation to establish the reportable income. If no acceptable alternative is found the UKEP will be retained.

3.17 One possibility is for a Reporting Fund to use, as a starting point for the calculation, IAS ‘Total Recognised Income or Expense for the period’ (or an exact equivalent such as the ‘Total return before distributions’ as computed under UK GAAP). The Government recognises that this figure includes both ‘income’ and ‘capital’ returns in the fund and that certain adjustments would need to be made to exclude amounts that would be recognised as capital for tax purposes were they in UK funds. Paragraphs 3.18 to 3.23 below consider this approach in more detail.

3.18 The Government recognises that certain offshore funds prepare their financial statements using accounting standards other than IAS. In such instances, if UKEP is replaced, it is intended that these offshore funds could be permitted to use an alternative GAAP in order to base their calculation of income. HMRC would maintain a list of alternatives, including UK GAAP, but in order to populate the list the onus would be on the fund to demonstrate to HMRC that the accounting basis figure proposed was a true alternative to the ‘Total Recognised Income or Expense for the period’ as set out in IAS.

3.19 This ‘total return’ figure (or alternative GAAP equivalent) will need to be adjusted for certain net gains or losses on investments during the period, and other gains or losses as defined by the IMA SORP. It is envisaged however, that those adjustments will not include any amounts relating to investments by the Reporting Fund in Non-Reporting Funds or in bond funds, whether or not the bond funds are Reporting Funds.

3.20 Investments with a return accounted for as, or in a similar way as, interest should be accounted for using the effective interest method to calculate interest income, as required by IAS. If the accounting method used treats amounts of ‘effective interest’ as being within gains or losses then an adjustment must be made.

3.21 It is also envisaged that adjustments will be made for ‘capital’ expenses. These would either be expenses directly related to gains and losses (for example, transaction costs, legal or performance fees) or relating to set up, merger or dissolution costs of the fund.

3.22 The Government is also undertaking work to consider whether adjustments are needed for new share issues, cancellation of shares and equalisation. It is anticipated that Reporting Funds that operate equalisation arrangements will continue to be subject to the same tax rules as apply in the current regime.

Point 7 for discussion: The Government welcomes views on the proposed computation of reported income, in particular to determine whether the above approach would reduce administrative burdens for funds or whether the retention of UKEP would be preferable.

Under the proposed computation the Government is also interested in views as to whether the ability to use other GAAPs is desired.

3.23 The current regime for distributing funds provides special treatment for commodity funds. The Government is considering whether similar treatment for such funds electing for Reporting Fund status would be appropriate.

Point 8 for discussion: The Government seeks comments from commodity fund stakeholders as to whether similar rules to the current treatment are still required.

Requirement (v) 3.24 Under the current rules, a distributing fund is required to physically distribute at least 85 per cent or more of its income as shown within the fund's accounts, and no less than 85 per cent of its UKEP. The Government recognises that physically distributing this amount may not be commercially attractive in some circumstances and is unhelpful for UK investors who wish to reinvest.

3.25 In order to treat UK investors in an offshore Reporting Fund as similarly as possible to those in a UK authorised fund, it is proposed that the modernised regime will require a Reporting Fund to annually report 100 per cent of its income (computed in accordance with the proposals set out in paragraphs 3.17 to 3.23). Therefore under the proposed regime the income reported can be:

- a physical cash distribution;
- a deemed distribution; or
- a combination of the above.

3.26 Like the current rules, the Reporting Fund's income calculated in accordance with either UKEP (if this is retained) or with paragraphs 3.17 to 3.23 above may exceed the Reporting Fund's income available for distribution calculated under its accounting standards. In these circumstances, the Reporting Fund's reported income to its UK and other Reporting Fund investors remains as computed in accordance with UKEP or paragraphs 3.17 to 3.23.

Point 9 for discussion: The Government welcomes views on (a) the requirements to annually report 100 per cent of the Reporting Fund's income and (b) allowing deemed distributions.

The Government also welcomes views on how the equalisation arrangements would operate in conjunction with the income calculation as set out in paragraphs 3.17 to 3.23.

3.27 Under the current offshore fund tax regime a *de minimis* provision is included to ensure that a distributing fund is still regarded as pursuing a full distribution policy if certain conditions are met. One such condition is that the gross income of the fund does not exceed 1 per cent of the average value of the funds' assets held in the period.

3.28 As set out in paragraphs 3.24 to 3.26, since the proposed regime allows for both physical and deemed distributions the Government does not believe that the modernised regime needs to include a *de minimis* provision. As with the current regime, where the total income for a period as computed in accordance with UK tax rules is a negative figure, the Reporting Fund will report nil income to its investors.

Point 10 for discussion: The Government welcomes views on the proposed exclusion of a *de minimis* provision within the modernised regime.

3.29 Offshore distributing accumulation funds currently have to agree ‘reinvestment mechanics’ with HMRC such that the distribution passes out of the fund’s control, is paid to a third party and is reinvested on behalf of the UK investor.

3.30 The Government believes these rules add complexity and therefore, as a further simplification, does not intend to include reinvestment mechanics requirements in the proposed new regime. Reported income that is not physically distributed will be treated as a reinvestment.

Point 11 for discussion: The Government seeks views on the proposal to remove the current ‘reinvestment mechanics’ requirements.

Breaching Reporting Fund conditions

3.31 Under the existing rules, breaches of the distributing status conditions can significantly affect UK investors. The Government intends to modernise the current rules that apply if a fund breaches the requirements.

3.32 The Government intends to include detailed regulations to provide for the situation where a Reporting Fund breaches the specified conditions in the new regulations. The intention is that where a breach is minor or inadvertent and remedied without undue delay, no adverse consequences will arise.

3.33 The rules for compliance with the Reporting Fund conditions will be simpler than the current regime. In the case of deliberate or repeated non-compliance, Reporting Fund status will be revoked and the fund will permanently ‘default’ to being a Non-Reporting Fund. To avoid unintended tax advantages, if this occurs, the fund will not be permitted to re-apply for Reporting Fund status at a later date.

3.34 The Government recognises that some funds which elect to be a Reporting Fund may decide, in future periods, that they no longer wish to comply with the UK offshore fund tax regime. Such funds, and their investors, will be treated for UK tax purposes in a similar manner to those where breaches cause a permanent ‘default’ to Non-Reporting Fund status.

3.35 Reporting Funds that are removed (as a result of a permanent breach) or choose to remove themselves from the regime, will treat the period before the removal as their last period as a Reporting Fund. This will have an effect on investors that is outlined in paragraph 5.16 to 5.19.

Point 12 for discussion: The Government welcomes views on paragraphs 3.31 to 3.35.

Non-Reporting Funds

3.36 Under the proposed regime, if an offshore fund does not elect to become a Reporting Fund, it will be considered a Non-Reporting Fund for UK tax purposes.

3.37 As with the current regime for offshore funds that do not apply for distributing fund status, the rules will not impose any requirements for Non-Reporting Funds.

4

REPORTING FUND INVESTMENTS INTO OTHER OFFSHORE FUNDS

4.1 This chapter outlines the Government's proposals where a Reporting Fund wishes to invest in other funds, including fund of fund structures.

4.2 The Government is aware that the current offshore funds tax regime creates barriers for funds wishing to invest into certain other funds. A key part of the proposals is therefore to modernise and simplify the requirements for funds wishing to obtain Reporting Fund status. The proposals will:

- remove the current investment restrictions which limit the extent to which distributing funds can invest in non-distributing funds (i.e. the 5 per cent rule); and
- reduce administrative burdens for offshore funds as a Reporting Fund will only need to consider its direct holdings.

Investments of a Reporting Fund into other offshore funds

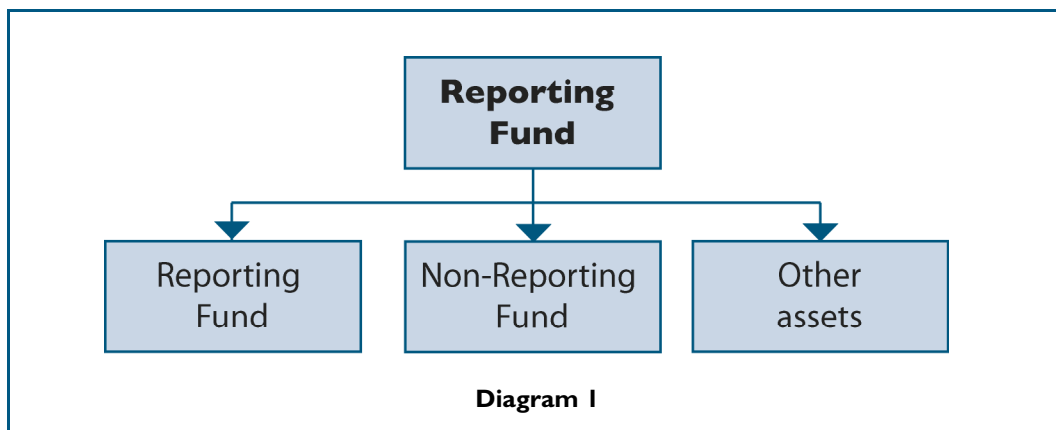
4.3 A current requirement of becoming a distributing fund is that the fund cannot invest more than 5 per cent by value of its assets in another offshore fund at any time in the period. The Government recognises that this rule restricts commercial development in funds that wish to have distributing fund status particularly since UCITS III regulations permit certain funds to invest up to 20 per cent of their assets in other funds.

4.4 The Government proposes to abolish the 5 per cent rule. The Government envisages that the removal of such a restriction will remove barriers currently inhibiting investment and reduce administrative complexities for offshore funds and their managers.

4.5 Finance Act 2007 introduced legislation that removed the layering restriction for distributing funds wishing to invest into other distributing funds. In line with this, it is intended that there will be no restriction on the number of layers that a Reporting Fund can invest into other funds.

4.6 Investments made by a Reporting Fund will generally fall into three categories for UK tax purposes:

- investments in Reporting Funds;
- investments in Non-Reporting Funds; and
- other assets.



Reporting Funds

4.7 Where a Reporting Fund invests into another Reporting Fund (other than a bond fund), it will receive information from that underlying fund to enable it to calculate its income to be reported. It will treat that income as arising on the reporting date of the underlying fund. As set out in paragraph 3.31 to 3.35, breaching conditions will be considered where a Reporting Fund investment is reclassified as a Non-Reporting Fund.

4.8 Where a Reporting Fund invests into another Reporting Fund that is a bond fund (as defined in paragraph 8, Schedule 10 Finance Act 1996) it will compute its investment based upon the change in value of its underlying investment in the fund. That is, it will 'fair value' its investment into that fund. This is similar to a Reporting Fund investing into a Non-Reporting Fund as described in paragraph 4.9.

Non-Reporting Funds

4.9 Where a Reporting Fund invests into a Non-Reporting Fund there are two possibilities:

- i. the Reporting Fund may not have any detailed information with regard to the Non-Reporting Fund investment or the Non-Reporting Fund may be a bond fund (as defined in paragraph 8, Schedule 10, Finance Act 1996). In such circumstances, it will 'fair value' its investment in the Non-Reporting Fund; or
- ii. the Reporting Fund may be able to access information from its investment into the Non-Reporting Fund and wish to treat that investment as if it were a Reporting Fund (i.e. treat it as a notional Reporting Fund). In those circumstances, if the Reporting Fund:
 - invests into a Non-Reporting Fund which does not fall within the definition of a 'bond fund' as set out in paragraph 8 Schedule 10 Finance Act 1996;
 - is able to demonstrate that the underlying fund has genuine commercial purpose and that its main purpose, or one of its main purposes of the fund is not the deferral or avoidance of UK taxation;
 - has access to the full accounts of that fund and can access sufficient information of that fund such that it can make the calculation of Reporting Fund income; and

- can rely on continued access to the above information for the period in which it will hold the investment;

it may account for its investment into that Non-Reporting Fund as if it were an investment into Reporting Fund.

4.10 To avoid unintended tax advantages, rules will be introduced so that it is not possible to ‘swap’ between treating that Non-Reporting Fund investment as a notional Reporting Fund in one period and treating the same investment as a Non-Reporting Fund in another period whilst the investment is held.

4.11 If the Reporting Fund no longer meets the criteria set out in paragraph 4.9 (ii), it must treat that investment as a Non-Reporting Fund (i.e. ‘fair value’ the investment) in all future periods.

Other assets

4.12 Where a Reporting Fund holds other assets (i.e. other investments which are not Reporting Fund or Non-Reporting Fund investments) such as equities, either through physically holding the investment or via a tax transparent vehicle, the Reporting Fund will be able to distinguish between income generated and capital growth.

Point 13 for discussion: The Government invites comments on the proposed treatment of a Reporting Fund investing into other Funds and, in particular, in the proposal set out in paragraph 4.9(ii) above to treat a Non-Reporting Fund as a notional Reporting Fund.

PROPOSED FRAMEWORK FOR INVESTORS

5.1 This chapter outlines the proposed tax treatment for investors in Reporting and Non-Reporting Funds.

5.2 Under the current offshore funds tax regime, specific rules apply for UK investors in offshore funds in which they hold a ‘material interest’. That is, they must reasonably expect to be able to realise their investment within seven years at a value reasonably approximate to market value.

5.3 The proposals for the tax treatment of UK investors into an offshore fund apply to UK investors’ investments into all offshore funds, as defined in Chapter 2. It is intended that the abolition of the ‘material interest’ concept will make the taxation of interests in offshore funds easier to understand as well as increasing certainty for UK investors.

5.4 The proposals are intended to align, as far as possible, the tax treatment of UK investors in offshore Reporting Funds with those in UK authorised funds.

Reporting date

5.5 The reported income (whether physically distributed or deemed) will be taxable on the UK investor in the normal way. It will generally be subject to tax on the investor in the period of assessment in which the reporting date falls. The reporting date will, in most cases, be the date on which the income is reported to investors. However, it may be possible to obtain unintended tax advantages if a fund reports its income a considerable time after the end of the period to which the Reporting Fund’s financial statements are drawn up (‘period end date’). Therefore, as for the distribution rules for UK authorised funds, if income is reported by a Reporting Fund more than four months after the period end date, the distribution will be treated in the hands of investors as being made on the period end date.

Point 14 for discussion: The Government welcomes comments on the proposed reporting date for investors.

Individual UK investors in Reporting Funds

5.6 Under the current offshore funds tax regime, an individual UK investor in a distributing fund is subject to UK taxation on the annual income distribution from the fund, and is subject to capital gains tax on the eventual disposal of their interest in that fund.

5.7 The Government proposes to retain these rules for UK individual investors in Reporting Funds. However, given that a Reporting Fund will be allowed to make either a real or deemed distribution, the UK investor will pay tax on the reported income irrespective of how much of it is physically distributed.

5.8 UK investors will not be subject to double taxation if they receive income that has previously been taxed, either in whole or in part, as deemed income. Where an individual is taxed on deemed income that has not been received when they dispose of their investment, the amount not received will be treated as a reinvestment cost in their

capital gain calculation on eventual disposal of their holding. This is similar to the treatment of UK investors in UK accumulation funds.

5.9 Individual UK investors in a Reporting Fund will be subject to tax in the tax year in which the reporting date falls. As in the current rules, the Government proposes that reported income (whether actual or deemed) will be treated as relevant foreign income (under the Income Tax (Trading and Other Income) Act 2005) for individual UK investors.

Point 15 for discussion: The Government invites comments on the proposed treatment of reported income from a Reporting Fund in the hands of UK individual investors.

UK corporate investors in Reporting Funds

5.10 Under the current offshore funds tax regime, a UK corporate investor's treatment in an offshore distributing status fund depends on its own particular tax circumstances. Specific adjustments may be required for certain corporate investors with specific tax regimes, for instance section 212 TCGA 1992 (annual deemed disposals of holdings certain assets of long-term insurance funds of insurance companies).

5.11 Aside from specific tax regimes, under the current offshore funds tax rules, to the extent that the corporate investor holds its interests in the distributing fund on trading account, it will be subject to tax on any profits from them under Case I of Schedule D.

5.12 If the distributing fund is a 'bond fund', as defined under Schedule 10 Finance Act 1996, the investment is treated as a creditor loan relationship and must be 'fair valued' for tax purposes at the end of each accounting period. In any other case, the UK corporate investor is subject to tax under Case V of Schedule D on the annual income arising and subject to tax under the chargeable gains rules on any disposal.

5.13 It is envisaged that in the new regime a UK corporate investor into a Reporting Fund would be treated in a similar manner to the current UK corporate investment in distributing fund. A UK corporate investor would be taxable on its share of income from a Reporting Fund whether it is actually distributed or deemed. That is, a corporate investor would treat a deemed distribution as arising for the purpose of Schedule D Case V or Schedule D Case I, as appropriate. It is proposed that the deemed distribution will be treated as taxable in the accounting period in which the reporting date falls (described in paragraph 5.5), subject to any overriding legislation.

5.14 Where the Reporting Fund in which the UK corporate has a holding is invested significantly in interest bearing or economically similar investments, Schedule 10 Finance Act 1996 will continue to apply as present irrespective of whether or not the fund is a Reporting Fund.

5.15 As for individuals, the UK corporate investor will not be subject to double taxation when receiving income that has previously been subject to tax as deemed income. Amounts taxed as deemed income but not actually distributed will be treated as reinvestments in the chargeable gain calculation on eventual disposal.

Point 16 for discussion: The Government invites comments on the proposed treatment of reported income from Reporting Funds in the hands of UK corporate investors.

Impact of change of Reporting Fund status on investors

5.16 Under the current offshore funds tax regime, where an investor holds a material interest in a distributing fund that loses that status in any period, the investor is treated as if the investment had always been into a non-distributing fund. The Government recognises that, in some circumstances, this treatment causes uncertainty.

5.17 Where a Reporting Fund becomes a Non-Reporting Fund, the Government intends that a investor should be treated as if they had always held a Non-Reporting Fund investment, in the same way as the current rules. Requiring investors to treat their investment differently between periods in which the fund is a Reporting Fund and a Non-Reporting Fund would entail complex legislation and result in complex calculations for the investor.

5.18 From a commercial perspective, it is reasonable to expect that a Reporting Fund wishing to remove itself from the regime would give prior notification to its investors so that those investors would consider whether they wished to continue with their investment.

5.19 The Government believes that, in some circumstances, this tax treatment may disadvantage investors if they are unaware that the fund no longer has Reporting Fund status. In order to provide certainty for UK investors and other Reporting Fund investors, details of the date from which Reporting Fund status is lost for the purpose of existing UK investors will be included in the intended regulations. The date will depend on the reason the status is lost. It is anticipated that, in most cases, the fund will have the opportunity to notify investors in time for them to disinvest if desired, to prevent those investors being subject to tax on an offshore income gain.

Point 17 for discussion: The Government is interested in views on the proposed treatment of UK investors where the Reporting Fund loses that status and ‘defaults’ into becoming a non-Reporting Fund.

Individual UK investors in Non-Reporting Funds

5.20 Under the current tax rules for offshore funds, an individual investor in an offshore fund that does not have distributing status is subject to tax when they dispose of their investment. Any profit on the investment is subject to tax as income and is known as an offshore income gain. This treatment results in the individual paying income tax on the capital growth of the investment as well as all undistributed income on the disposal of their investment. The offshore income gain aims to compensate, to an extent, the UK Exchequer for the fact that the UK investor is able to defer tax on income arising within the fund until eventual disposal.

5.21 In developing its proposals for the tax treatment of individual investors into Non-Reporting Funds the Government has balanced two key objectives:

- to ensure that, as far as possible, UK investors’ decisions are based on commercial decisions such as the objectives of the fund, the underlying asset base and the fund managers’ expertise, rather than UK tax treatment; and
- as far as possible to tax investment in offshore funds in the same way as investment in UK funds.

5.22 On this basis, the Government is proposing that the current offshore income gains treatment be retained. Individual investors in Non-Reporting Funds will be subject to income tax when they dispose of their investment.

5.23 The Government intends also to close a loophole in the offshore income gain rules. If a person moves abroad and realises a gain on disposal of their investment, they will be subject to UK income tax if they return to the UK within a five year period. This is similar to the current capital gains tax treatment for temporary non-resident individuals (see section 10A TCGA 1992). This will ensure that unintended tax advantages are not obtained by individuals leaving the UK in any given tax year and subsequently realising their investment free of UK tax.

Point 18 for discussion: The Government invites comments on the proposed treatment of UK individual investors in Non-Reporting Funds.

UK corporate investors into Non-Reporting Funds

5.24 Under the current offshore funds tax regime, UK corporate investors treat their investment in a non-distributing fund as giving rise to an offshore income gain in the year of disposal, unless they are subject to specific loan relationship rules. As with the current regime, corporate investors with specific tax regimes (for example, section 212 TCGA 1992) may require specific adjustments.

5.25 As for individuals, the Government intends to retain the offshore income gain treatment for UK corporate investors in Non-Reporting Funds which do not fall to be a loan relationship within Schedule 10 Finance Act 1996. As for the current rules, where the Non-Reporting Fund is invested significantly in debt securities, interest bearing or economically similar investments, the loan relationship rules will continue to apply.

Point 19 for discussion: The Government invites comments on the proposed treatment of UK corporate investors into Non-Reporting Funds.

Change of Non-Reporting Fund status for investors

5.26 In order to avoid the need for complex legislation and calculations, the Government proposes that a UK investor is taxed on the basis of the fund's status when they acquired their investment in a Non-Reporting Fund. This means that if an investor invests into an offshore fund when it is a Non-Reporting Fund and that fund subsequently obtains Reporting Fund status, the investor will continue to treat their investment as if it is in a Non-Reporting Fund. If the investor wanted to take advantage of the 'new' Reporting Fund status they would need to dispose of their original investment and reinvest in the fund.

Point 20 for discussion: The Government welcomes comments on the proposed treatment of investors, where a Non-Reporting Fund changes its status to become a Reporting Fund.

5.27 The Government also intends to include transitional provisions to provide continuity of tax treatment for UK investors where a distributing fund wishes to become a Reporting Fund.

6

INTRODUCTION TO IMPACT ASSESSMENT

6.1 The Impact Assessment (IA) is published within this document and should be read in conjunction with it. The IA considers qualitative, and where possible, quantitative costs and benefits for the proposals to modernise the offshore funds tax regime. This is a consultation stage IA, which is reflected in the fact that there are, as yet, no quantitative estimates.

6.2 The Government will continue to undertake further analysis during the consultation period with the intention of publishing a subsequent version of the IA with the final set of draft regulations. The Government welcomes comments and evidence from interested parties to aid with the analysis used in this impact assessment, and directs interested parties to specific questions that are set out on pages 3 and 4 of the IA. A copy of the IA can also be found on HM Treasury's website www.hm-treasury.gov.uk.

7

NEXT STEPS

7.1 This discussion paper describes the Government's proposals for the modernisation of the tax regime for offshore funds. The Government recognises that there are a number of issues affecting UK investment in offshore funds and is committed to engaging with and inviting comments on the proposals set out in this document.

7.2 The Government will continue to develop these proposals in parallel with the Financial Services Authority's consultation (CP07/6) 'Funds of Alternative Investment Funds' regime and the recent HM Treasury publication, 'Taxation of the foreign profits of companies: a discussion paper'.

7.3 This discussion paper does not discuss transitional provisions between the current offshore funds tax regime and the new regime. Subject to responses, the Government intends to address transitional issues when issuing draft legislation.

7.4 Interested parties should send their comments by Wednesday 9 January 2008 to:

Sue Harper
Assets, Savings and Wealth Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: +44 (0)207 270 6031

Email: sue.harper@hm-treasury.gov.uk

7.5 Subject to responses to this discussion paper, the Government remains committed to introducing legislation for a modernised regime in Finance Bill 2008 and intends to issue draft regulations in the New Year.

Confidentiality Disclosure

Information provided in response to this discussion paper, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004).

If you ask us to treat the information that you provide as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

The Department will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

About the consultation process

7.6 This paper has been conducted in accordance with the consultation criteria in the Cabinet Office Code of Practice. If you wish to access the full version of the Code, you can obtain it at

<http://www.cabinetoffice.gov.uk/regulation/consultation/code/index.asp>

The consultation criteria

- Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
- Be clear about who may be affected, what questions are being asked, and the timescale for responses.
- Ensure that your consultation is clear, concise and widely accessible.
- Give feedback regarding the responses received and how the consultation process influenced the policy.
- Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
- Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

If you feel that the consultation does not satisfy these criteria, or if you have any complaints about the process, please contact –

Duncan Calloway
Better Regulation Unit
+44 (0)20 7147 2389
duncan.calloway1@hmrc.gsi.gov.uk

Freedom of Information contact

Any Freedom of Information Act queries should be directed to:

Correspondence and Enquiry Unit
Freedom and Information Section
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Telephone: +44 (0)20 7270 4558

Fax: +44 (0)20 7270 4681

E-mail: public.enquiries@hm-treasury.gov.uk

Summary: Intervention & Options

Department /Agency: HM Treasury	Title: Impact Assessment of "Offshore Funds: A Discussion Paper"	
Stage: Consultation Stage	Version: 1	Date: October 2007
Related Publications: "Offshore funds: a discussion paper"		

Available to view or download at:

<http://www.hm-treasury.gov.uk>

Contact for enquiries: Sue Harper

Telephone: 0207 270 6031

What is the problem under consideration? Why is government intervention necessary?

The main purpose of the offshore funds regime is to establish the tax treatment of activities which seek to use certain offshore funds to convert income flows into capital gains. The marketplace for funds has changed significantly since these rules were introduced in 1984. As a result of commercial and regulatory developments, the Government announced in October 2006 that it would consult to ensure that tax regime does not act as a barrier to the commercial development of multi-tiered funds.

What are the policy objectives and the intended effects?

The intention is to allow, as far as possible, UK investors to make investment decisions based on commercial, rather than for tax reasons. One of the main objectives is to remove UK tax barriers to multi-tiered fund structures. The Government also aims to simplify the operation of the regime, provide more certainty to funds and UK investors, and to strengthen the existing anti-avoidance rules.

What policy options have been considered? Please justify any preferred option.

1. Do nothing - this would mean the tax rules continue to impede the development of multi-tiered fund structures that are permissible under regulatory rules.
2. Modernise the offshore funds tax regime - this would remove the restrictions that impede these development of multi-tiered funds, as well as increasing simplicity and certainty for funds and UK investors.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The Government intends to monitor the effects of the final reform package on an ongoing basis.

Ministerial Sign-off For consultation stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:



Date: 4-Oct-07

Summary: Analysis & Evidence

Policy Option:	Description:
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COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups' The Government envisages that the managers of funds opting to become Reporting Funds under the proposed reform will incur a small one-off cost in familiarising themselves with the new tax rules. HMRC will also incur a minor one-off cost in amending its systems.
	One-off (Transition)	Yrs	
	£ negligible	1-2	
	Average Annual Cost (excluding one-off)		
	£ negligible		
Total Cost (PV)			£ negligible
Other key non-monetised costs by 'main affected groups' None			

BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups' The Government is undertaking work to cost the expected reduction in administrative burdens to industry, using the Standard Cost Model, as well as other expected savings (see the section on evidence base below for further details).
	One-off	Yrs	
	£ tbc		
	Average Annual Benefit (excluding one-off)		
	£ tbc		
Total Benefit (PV)			£ tbc
Other key non-monetised benefits by 'main affected groups' The Government expects that UK investors will significantly benefit from more choice, certainty and simplicity when making offshore investments. Offshore funds electing to be Reporting Funds will significantly benefit from more certainty and simplicity (see section on evidence base below for further details).			

Key Assumptions/Sensitivities/Risks

At this stage, several uncertainties remain. The Government welcomes comments and evidence from interested parties to aid with the analysis used in this impact assessment.

Price Base Year	Time Period Years	Net Benefit Range (NPV) £ tbc	NET BENEFIT (NPV Best estimate) £ tbc
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What is the geographic coverage of the policy/option?	UK
On what date will the policy be implemented?	Royal Assent 2008
Which organisation(s) will enforce the policy?	HMRC
What is the total annual cost of enforcement for these organisations?	£
Does enforcement comply with Hampton principles?	Yes
Will implementation go beyond minimum EU requirements?	N/A
What is the value of the proposed offsetting measure per year?	£ 0
What is the value of changes in greenhouse gas emissions?	£ 0
Will the proposal have a significant impact on competition?	No
Annual cost (£-£) per organisation (excluding one-off)	Micro Small Medium Large
Are any of these organisations exempt?	No No N/A N/A

Impact on Admin Burdens Baseline (2005 Prices)		(Increase - Decrease)
Increase of £ tbc	Decrease of £ tbc	Net Impact £ tbc

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Evidence Base (for summary sheet)

Compliance Savings and Costs

Informed by discussions with industry to date, the Government expects there to be substantial savings to industry in the areas set out below:

- Funds will be able to elect to have Reporting Fund status from HMRC at the outset. This will provide greater certainty for funds following this route (paragraphs 3.8 to 3.10)
- Funds will be less likely to lose their Reporting Fund status from inadvertent breaches. This will increase certainty for Reporting Funds (paragraph 3.32).
- Abolishing the 5 per cent investments restriction test will provide more certainty to funds, as well as removing the need to monitor for tax purposes the underlying investments that it makes (paragraph 4.4).
- A further simplification will be to remove the reinvestment mechanics required by the current rules (paragraph 3.30).

Point 21 for discussion: *Monetising all the compliance savings and costs generated by the proposed modernisation is complex. The Government would welcome evidence from industry to aid with quantifying these. The Government would also welcome comments on whether industry expects other areas of the proposals to generate compliance savings and costs.*

Administrative Benefits and Costs

The Government has undertaken some initial analysis, based on a comparison of the obligations that funds have in terms of making applications and submitting the required information to HMRC under the current offshore funds tax rules, and the proposed modernisation. The annual administrative burden savings are taken as the simple product of a) the number of funds affected and b) an estimate of the cost saving per fund. The latter is calculated according to HMRC's Standard Cost Model (SCM) methodology, which, in particular, distinguishes costs according to the size of firm and whether key operations are handled in-house or outsourced (for further information on the SCM approach to estimating administrative burdens go to www.hmrc.gov.uk/better-regulation/kpmg.htm).

The savings in administration costs arising from the proposed changes are very difficult to predict at this stage. However the Government believes that the following aspects of the proposals are likely to reduce administrative costs:

- Making an application to HMRC once, in advance of the entire period in which a fund wishes to be a Reporting Fund, instead of the annual application required under the current regime (paragraphs 3.8 to 3.10)
- No requirement to show that the 5 per cent investment restriction was not exceeded, where this is required under the current regime for the entire period of account (paragraph 4.4).
- No details of any holdings in other offshore funds, stating the type of fund (that is whether it is qualifying or non-qualifying), which is required under the current regime.

Initial estimates show that the proposed modernisation is likely to achieve a saving per fund of 10 per cent in administrative costs, when compared to the current offshore fund rules.

In addition to the annual benefits generated by the reform proposals, there will also be some small one-off costs incurred by: (a) the managers of funds, who will need to familiarise themselves with the new rules; and (b) HMRC, who will need to modify their administration and compliance processes to accommodate the changes to the tax rules. The Government anticipates that in total these one-off costs should be negligible.

Point 22 for discussion: *The Government welcomes views from interested parties on whether the aspects of the proposals are likely to reduce administrative costs, and on any evidence that may be helpful in providing a quantitative estimate of these savings.*

UK Investors

The proposals for modernising the offshore funds tax regime will benefit UK investors by providing them with more certainty in terms of their tax treatment in comparison to the current offshore funds tax rules. This is because:

- UK investors will have certainty that they will be treated by HMRC as investing into a Reporting Fund, whereas under the current regime the tax treatment will depend on whether a fund is awarded “distributor status” at the end of the accounting period (paragraph 3.7)
- Breaches of distributing status conditions by an offshore fund can significantly affect UK investors. Since it is proposed that several of the tests, such as the investment restrictions test, will be removed, breaches will be less likely.

In addition to this increased certainty, it is intended that the abolition of the ‘material interest’ concept will make the taxation of interests in offshore funds easier to understand (paragraph 5.3).

Finally, the proposals offer an opportunity for a simpler and less burdensome tax regime for offshore funds wishing to market themselves into the UK. Subject to market conditions, the Government expects that at least some of those funds that currently do not have “distributor status” will choose to benefit and elect to be Reporting Funds, although there is no firm evidence to ascertain how many funds will do this. This will increase the choice that UK investors have when choosing in which vehicles to invest.

Point 23 for discussion: *Monetising the benefits to UK investors from the greater certainty, simplicity and choices they may have from the new regime, is complex. However, the Government believes that qualitatively, there will be a significant, positive effect, and would welcome comments from interested parties on this.*

Competition Assessment

The Government envisages that the reform proposals will have a small, positive effect on the UK retail investment market, particularly in terms of enabling new types of investment business to be sold into the UK market. The proposals contained in the discussion paper offer an opportunity for a simpler and relatively less burdensome tax regime for offshore Reporting Funds. This should enable UK funds to operate more efficiently in competition for retail market business. Specifically, the reform proposal should enable Reporting Funds to compete more effectively in the marketplace.

Whilst at this stage there is no firm evidence to ascertain how many funds from among the current set of non-Distributing funds will opt to become Reporting Funds, the Government would expect that at least some will choose to benefit from the proposed reform of the tax rules governing offshore funds.

Small Firms Impact

The proposals affect firms of all sizes and so the overall savings in admin burdens reported above will be shared by small and large firms alike. Based on an analysis of the number of funds operated by each firm, the Government estimates that around 45 per cent of the firms affected could be classed as small (including micro).

Specific Impact Tests: Checklist

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	No	No
Disability Equality	No	No
Gender Equality	No	No
Human Rights	No	No
Rural Proofing	No	No

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