Taxing Funds & Other Investments – Real-life Scenarios

The tax rate on fund investments has changed dramatically in recent years. In 2008 the tax rate on fund gains was only 23%, whereas it is now a whopping 41%. The same applies to Irish and EU deposit interest, which in 2008 was taxed at 20% (plus PRSI/health contribution where applicable) and is now taxed at 41% (plus PRSI where applicable).

Because the rates of tax on Irish and EU investments have increased significantly, there is no longer a strong incentive to invest money within Ireland and the EU, as the disparity between the tax rates on EU and non EU investments has narrowed. In the case of deposit interest, there is no longer any difference between the tax rates on Irish/EU deposit interest (41% plus 4% PRSI) and deposit interest from outside the EU (also 41% and 4% PRSI), while in 2008 the disparity between the two rates was 21%. Clients who may have chosen to house their deposits within the EU in order to obtain a lower tax rate should perhaps revisit the various rates on offer for deposits to ensure that, given the changes in tax treatment, their strategy is still correct.

Current tax rates

The current rates of tax (and some other relevant points to note) on the main types of investment we will meet in the presentation today are set out below.

The rates shown are the maximum rates. In some cases clients will not be liable to PRSI and may be liable to a lower rate of USC.

- Irish and EU deposit interest: 41% income tax, 4% PRSI

- Non-Irish, non-EU deposit interest: 41% income tax, 4% PRSI

- Equities (provided they are not considered fund investments): dividend income taxed at 55% (41% income tax, 4% PRSI, 10% USC), gains on the sale of the shares are liable to capital gains tax, currently 33%, and can be sheltered by losses

- Gains on funds within Ireland, the EU, EEA and OECD countries with which we have a Double Taxation Agreement (DTA): income tax 41% (which cannot be sheltered by losses). Losses are not allowable, and there is an 8 year charge

- Gains on funds outside the EU/EEA/OECD DTA countries: 41% income tax, 4% PRSI and 10% USC. Gains cannot be sheltered by losses but any losses made on non EU funds are allowable for CGT purposes. No 8 year charge

- Income from Irish and EU funds: income tax 41%

- Bond investments: income is taxed at 41%, PRSI 4% and USC 10%. Gains liable to capital gains tax at 33% with exemptions for Irish Government Bonds and certain other bodies e.g. Bord Gáis/Irish Water. It is arguable that this exemption should extend to bonds issued by other EU Governments/government bodies – see Commission of the European Commission v French Republic c-334/02. In this case it was held to be a discriminatory practice to apply a higher rate of tax to investment income arising in another EU country as opposed to the home country.

One of the (unintended?) consequences of the recent changes in funds tax which increased the rate to 41% is that the tax rate on EU funds is now 41% in all cases (unless we are dealing with a personal portfolio investment undertaking, PPIU). Previously, if the fund gain was correctly declared on a timely tax return, the gain was taxed at the funds tax rate but this was then increased to the individual's marginal tax rate if the gain was not returned correctly. Now if the funds tax rate and the individual's marginal rate of tax are both 41%, the rate is no different if the investment is not correctly returned. Of course, interest/penalties will apply if the investment has not been returned correctly but the additional income tax charge that used to exist no longer does. This is good news particularly for tax advisers, as the fact that the rate increased if an item was not reflected correctly on a tax return heightened the risk for accountant/advisers in completing returns involving investment portfolios with fund investments.

Fund investments – a feature of almost all portfolios

Laura mentioned in her presentation that typically, if we were to look at the portion of her client portfolio that is invested in equities, somewhere between 30% and 50% of the

equity investments would be through the medium of funds. In my experience, it is rare to find a client who has an investment portfolio that does not include fund investments (although they often do not know that this is the case). In general, having this level of fund investments within a portfolio does not pose any difficulty from a tax perspective, but there are always points to watch. Some key points to bear in mind if a client has a fund investment within the EU/EEA/ OECD DTA countries are set out below (these points would apply equally to investments through a life policy, as they are subject to a similar regime):

- It is important to pick up the 8 year charge (i.e., once the investment has been owned for 8 years, it is deemed to have been disposed of and reacquired at market value). So a fund that was acquired in April 2005 and is sitting at a gain in April 2013, is deemed to have been disposed of in April 2013 and the 8 year charge will need to be reflected on the client's 2013 tax return

- Where the fund is an Irish fund, the administrator deducts tax on the 8 year anniversary. In that case, the client is not required to return the 8 year charge on his/her returns. In these situations often the tax adviser never sees the amount of tax that is deducted. Then if the client exits from the fund in say year 10, the administrator must adjust the tax in year 10 so that overall during the course of the 10 year investment, the investor pays the same amount of tax that he/she would have paid if the 8 year charge had not existed. In cases where the client is non-resident and non-ordinarily resident in year 10, this means that there is no tax on exit and the client should receive a refund of the 8 year charge. Where the fund has dropped in value below the value in year 8, again there should be some level of refund of the 8 year charge when the client encashes at the end of year 10. I have found that not all of these calculations are correctly prepared and therefore if you have a client who has cashed out of a fund or life policy where the 8 year charge was paid during the lifetime of the fund, I would suggest that you review the calculation on exit to ensure that the tax has been calculated correctly and that the client is not due any additional refund

- Investors should be careful where they have an Irish fund not to assume that the administrator will deduct exit tax. In more and more cases, Irish funds are not

deducting exit tax, one reason for this being that funds held in a recognised clearing system (e.g. Euroclear) are not required to operate exit tax, and increasing numbers of funds are falling into this category. In those cases, a payment from the fund must be returned by the investor on his/her tax return as if it was a payment from a fund within the EU/EEA/OECD

- Funds (and deposit interest) are now taxed at 41% regardless of whether the client has other income. So for a low income taxpayer, who is not using his/her 20% tax band, these investments may be inappropriate as they are taxed at 41% whereas income taxed at marginal rates (e.g. dividends, bond interest) would be taxed at 20% and could be offset by personal allowances.

Identifying a fund investment

As seen from Laura's presentation, the norm is that a portfolio will contain a number of investments that could be considered funds for tax purposes. However, it is not always clear from simply looking at the name of the investment and its country of residence, whether it should be treated as a fund for tax purposes or not.

Further difficulties arise out of the fact that two or more investments may have similar names but be structured very differently. For example, in all of the categories below I have seen some investments that in my view are categorised as capital gains tax investments and others that are categorised as funds:

- iShares
- Investment trusts
- ETFs
- SPDRs.

This goes to show that there can be no "one size fits all" rule; each investment needs to be analysed on its own merits to determine whether or not it is a fund for tax purposes.

The rules are different for fund investments inside the EU/EEA/OECD countries with which Ireland has a DTA, and outside those countries.

Investments outside EU/EEA/OECD DTA countries

Starting firstly with the non-EU/EEA etc. countries (examples being Jersey, Cayman Islands, Isle of Man, Bermuda and many others), the main rule is that virtually all types of investment vehicle that would be used by stockbrokers to access equities/bonds indirectly are considered funds for tax purposes. There are some technical arguments that can be made if you wish to show that an investment is not a fund, the main two being:

1. If the fund trades at a significant discount to NAV, there is an argument that it cannot be considered a fund investment because the investor does not have a "reasonable expectation" of realising an amount that is reasonably approximate to the NAV of the fund. I would be cautious of this argument. My experience is that if there is a correlation between net asset value and the fund price, even where there is quite a bit of disparity, Revenue's inclination is to treat the investment as a fund. In addition, the legislation seems to suggest that if the investor could expect the fund to trade at or about any NAV **at any point** during the 7 years after investment, then it should be considered a fund, even if a fund constantly trades at quite a wide divergence to NAV. Looking back over the history of any investment fund, I suspect at some point during each 7 year period it would happen to trade at or around NAV. Therefore, this is not necessarily a particularly good argument but it may be helpful in certain cases.

2. In the case of hedge funds or property funds, particularly where loans have been secured on the assets of the fund, there is an argument that the investment cannot be considered a fund investment. This is because a material interest in an offshore fund is one where an investor can realise a certain proportion of the market value of the assets of the fund [section 743(3)]. Market value in this context is to be determined in accordance with the CGT rules [section 743(9)]. The CGT rules in turn provide that when determining the market value of an asset [section 737], one is to ignore borrowings secured on the asset. Therefore, where a fund has borrowings the investor will only be able to realise a certain percentage of the net value of the fund's assets, never the gross value and therefore one could argue that the interest should not be considered a material interest in an offshore fund. The interaction of the CGT legislation and the offshore fund legislation is far from perfect in this context.

Funds within the EU/EEA/OECD DTA countries

Since the changes in Finance Act 2007, the definition of a "fund" is much narrower in the context of investments within the EU/EEA/OECD countries with which Ireland has a DTA. In those cases, the investment must fall within certain clearly defined parameters in order to be considered a fund for tax purposes.

It is worth looking closely at the legislation in this area, which I shall do in a moment.

Firstly, a very simple summary of the rules in relation to funds within the EU/EEA/OECD countries is:

- If the investment is not UCITS authorised and is not authorised or regulated by anyone, then it is not a fund

- If it is UCITS authorised, it is definitely a fund

- If it is authorised/regulated by some authority but is not UCITS authorised, then more analysis is required.

The specific legislation in point is at section 747B, which lists the items that are to be considered a fund for tax purposes in sub section 2A. Paraphrasing, there are four types of fund, which are:

1. Certain authorised collective investment undertakings that are similar in all material respects to an Irish Investment Limited Partnership. In the context of quoted investments, these types of investment are rarely if ever seen so I have not included any further detail on this.

2. An investment that is authorised under measures taken by a Member State to give effect to the UCITS directive. Generally, the prospectus for any investment (often available on the internet) will state if it is a UCITS investment. If it is, then you do not need to do any further analysis as it is considered a fund for tax purposes. You should be careful however to ensure that the fund is authorised under the UCITS directive; some prospectuses will state that an investment is "UCITS compliant"

which does not necessarily mean that it is authorised under the UCITS directive and may simply mean that it could be authorised if it chose to be.

3. An authorised investment company that is similar in all material respects to an authorised investment company (within the meaning of part XIII of the Companies Act 1990), and which raises capital for promoting the sale of its shares to the public. There are a number of key components here:

    - The investment must be authorised by the authorities of the state in which it is formed, under laws providing for the proper and orderly regulation of such companies

    - The investment must be similar in all material respects to an authorised investment company (within the meaning of Part XIII of the Companies Act 1990)

    - The fund must raise capital by promoting the sale of its shares to the public.

    On a practical level it is often difficult to decide whether "foreign laws" provide for the proper and orderly regulation of the company". Therefore, it can be more practical to focus instead on the other two conditions, both of which can generally be ascertained from a review of the prospectus for the particular investment.

4. The final category is an authorised unit trust scheme, which is similar in all material respects to an Authorised Unit Trust Scheme within the meaning of the Unit Trusts Act 1990, and provides facilities for the participation by the public, as beneficiaries under the trust, in profits or income arising from the acquisition, holding, management, or disposal of securities or any other property whatsoever.

I would like to focus on two of the conditions above which are often overlooked. In order to be a fund, if the investment is structured as a company, it must *"raise capital by promoting the sale of its shares to the public".* If it is a unit trust scheme, it must *"provide facilities for the participation by the public, as beneficiaries under the trust, in profits or income….."*

So an investment company which raises capital in some other form as opposed to by promoting the sale of its shares to the public, is not considered a fund for tax purposes. Equally, a unit trust scheme is not a fund unless the public participate “as beneficiaries under the trust” in profits or income from the investments. Depending on the structure of the investment in question, it may be arguable that there is no trustee/beneficiary relationship.

Example

Laura has mentioned the iShares Euro STOXX Exchange Traded Fund as an example of an investment that she might suggest to a client as part of a balanced portfolio. This investment is not regulated under the UCITS Directive which means that further analysis will be required before the tax treatment of the investment can be determined. How does a practitioner decide if the company raises capital by promoting the sale of its shares to the public?

The answer can be found in the prospectus. The iShares funds do not promote the sale of shares to members of the public. All of Blackrock AG’s shares are held by a company in the parent group. Blackrock AG raises capital for the iShares funds by promoting the sale of certificates in bearer form. Certificates are not considered shares when generally interpreting tax legislation, so arguably this investment is not a fund.

Similar in all material respects

The other condition that needs to be met in the case of a company is that it is “similar in all material respects” to an Authorised Investment Company within the meaning of Part XIII of the Companies Act 1990. In the case of a unit trust scheme, there is a corresponding requirement that it must be similar in all material respects to an authorised unit trust scheme within the meaning of the Unit Trusts Act 1990.

Looking at Part XIII of the Companies Act 1990 and the Unit Trusts Act 1990, one point that strikes me is that those Acts do not set out very many conditions that need to be met in order for an investment to be considered a Part XIII Investment Companies/an Authorised Unit Trust scheme. There are some key features. Therefore, if those key features are not present, in my view it is reasonable to conclude that the investment is not “similar in all material respects” to its Irish equivalent.

In the case of a unit trust, a key feature of an Irish regulated unit trust is that it must provide facilities to investors to redeem their units directly with the trustees.

When you sell shares in a unit trust, they are sold back to the unit trust company. If offsetting buyers are not available then the number of outstanding shares is reduced and some underlying shares in the company that make up the index being tracked will have to be sold to finance the outflow of cash caused by the redemptions.

Many foreign ETF – type investments that are structured as unit trusts do not provide this facility and the only way that an investor can realise value for his or her units is by selling them on the open market.

This is because the units in the investment consist of block-size creation units (usually c.50,000) and can only be redeemed in creation units. As a result, only large institutional investors can redeem units directly with the trust and therefore it is not possible for individual investors to purchase or redeem units directly with the Trust. Individual investors can only trade shares on a secondary market on a Stock Exchange.

Quite often it is possible to see from the prospectus for the investment that this is how the investment operates. For example, in the case of the SPDR Pharma ETF (part of the SPDR Series Trust) investment there is a reference in the prospectus to the "creation units" purchased initially in the fund by large institutional investors who may in turn sell all or part of them on a secondary market on a stock exchange.

The other interesting aspect of many ETF investments is that they are not actively managed. In most cases the portfolio of stocks in the investment is fixed (i.e. it is decided at the outset exactly what mix of securities the investment will hold). The almost total absence of change in the investment's portfolio eliminates the need for the trust to contract with an investment adviser for management services. By contrast the Irish equivalent of this investment must have both a management company and a trustee in place.

In my view these are key differences and I would conclude that a unit trust structured in this way, which is not a UCITS investment, is not a fund investment at all.

ETF and similar investments structured as corporates rather than trusts are also often structured in the same way (i.e. with "creation units" issued to institutional investors, and no facility for individual shareholders to redeem their units directly with the company). This to me would appear to be a key difference with an Irish Part XIII authorised investment company, which must either redeem units for investors or take steps to ensure that its shares will trade within a specified percentage of NAV, the percentage to be no more than 5% and to be specified in the company's memorandum and articles of association.

Do you definitely have a fund?

I have come across a number of cases recently where a client has failed to pay tax on a fund investment and is looking at paying the overdue tax now. This could arise for a number of reasons:

- The client may have missed the 8 year charge
- They may have misunderstood the nature of the investment and thought that it was covered by CGT losses
- They may have assumed that because it was an Irish fund, an administrator was deducting tax.

The default position would be to assume in that in those circumstances, you are returning (late) a gain on a fund investment that will be liable to top rate income tax on the gain, together with interest and penalties.

Before making the cheque out to Revenue, the question I would ask is should the client definitely make this settlement? Can you argue that the gain is not a fund gain but a CGT gain, which would reduce the rate to the CGT rate, and in many cases result in no tax as the client may have CGT losses forward.

There are a number of possible arguments that could be advanced as to why an investment should be treated as capital gains tax rather than a fund investment. Some of the arguments are better than others, and some will only be relevant in certain limited cases, but for reference they are set out below:

- Does the fund have borrowings? (see comments under the heading “identifying a fund”)

- Does the fund trade at a figure that is significantly divergent from NAV, ideally at a significant discount? (see comments under the heading “identifying a fund”)

- Can you argue that it is not authorised or regulated, or if it is, that it is not authorised/regulated by the authorities of the State in which it was formed / is resident?

- Can you argue that it is not materially similar to an Irish Authorised Investment Company / Authorised Unit Trust scheme?

- In the case of a company, does it raise capital by promoting the sale of its shares to the public?

- In the case of a unit trust scheme, are the investors participating “as beneficiaries under the trust”?

The Irish tax legislation raises as many questions as it provides answers. This is one area where radical simplification is needed. Until then, I hope the above is of some assistance.

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April 2014