Offshore funds – Irish Tax Considerations

by Mairéad Hennessy

The very mention of offshore funds can make the most composed tax adviser break into a cold sweat. Why, you may ask?

It is because advising on the tax treatment of an offshore fund involves delving into a maze of complex rules. The legislation is difficult to follow and there is limited guidance available. This means that there is a greater risk of non-compliance than for more traditional investment options. Failure to correctly declare acquisitions, disposals (including deemed disposals), income and other fund transactions can result in expensive interest and penalties for the investor, as well as the risk of a Revenue Audit. Against this backdrop, advisers are understandably nervous when advising clients.

Collective investment vehicles which are domiciled outside Ireland are typically regarded as being "offshore funds" as defined under Irish law. Offshore funds fall into different categories which have unique tax treatments.

Notwithstanding the complexities around the tax treatment of offshore funds, their popularity has soared in recent years amongst Irish and overseas investors. Recent interest rate increases is one factor that has encouraged investors to consider alternative investments that may provide a reasonable expectation of income and growth while protecting their capital through investment in diversified sources.

Tax treatment of Offshore Funds

If an investment in an offshore (i.e., non-Irish) fund is a "material interest", then the investor will be subject to the offshore fund tax regime.

Generally, an investor has a material interest in an offshore fund if, at the time the investor acquired the interest, it could be reasonably expected that at some time during the period of 7 years beginning at the time of acquisition, the person will be able to realise the value of their investment in some manner.

Once it has been established that the investment is a "material interest" in an offshore fund, then the investment will fall into one of the following categories:

1. "Equivalent" offshore funds based in the EU, EEA or an OECD country with which Ireland has a DTA, i.e.
   - The fund is authorised as a UCITs, or
   - The fund is similar in all material respects to an Irish authorised investment company, is authorised and regulated in its country of domicile, or
   - The fund is similar in all material respects to an Irish authorised unit trust, is authorised and regulated in its country of domicile.
2. "Non-equivalent" offshore funds based in the EU, EEA or an OECD country with which Ireland has a DTA, i.e., the fund is domiciled in the EU, EEA or OECD with which Ireland has a DTA, and the fund is not an "equivalent" fund, as outlined above;
3. Offshore funds that are not based in the EU, EEA or an OECD country with which Ireland has a DTA (e.g., Caymen, Bermuda etc).

The following is a high-level summary of the Irish tax treatment pertaining to the three categories of offshore investments.

"Equivalent" offshore funds in EU, EEA or OECD/ DTA countries

- Income distributions to an investor are subject to income tax at 41%, no PRSI or USC applies;
- Gains arising from the disposal of units are subject to income tax at 41%, no PRSI or USC applies;
- The investor is deemed to dispose of and reacquire their investment at its market value every 8 years, which may trigger deemed gain. The tax paid on this deemed disposal is taken into account when the investment is actually disposed of;
- The investor is deemed to dispose of and reacquire the investment at its market value at the date of death,

which may trigger a taxable deemed gain;

- The remittance basis of taxation applies to income but not to gains from these funds;
- Losses arising on the disposal (or deemed disposal) of units by an investor cannot be offset against other gains.

"Non-equivalent" offshore funds in EU, EEA or OECD/ DTA countries

- Income distributions to an investor are subject to normal income tax rules i.e., marginal rate income tax, PRSI and USC;
- Gains arising from the disposal of units are subject to normal CGT rules i.e., the 33% CGT rate;
- There is no deemed disposal of the investment every 8 years;
- No CGT arises on the deemed disposal on the death of the investor and the personal representatives are treated as acquiring the investment at market value at the date of death;
- No tax arises on the transfer to the investor's spouse/ civil partner during their lifetime;
- Any losses on disposal may be offset against other gains subject to CGT;
- Both income and gains should qualify for the remittance basis of taxation for non-domiciled investors.

Many offshore funds comprise investments in Exchange Traded Funds (ETFs), and this covers a wide range of investments. Prior to 1 January 2022, Revenue treated all ETF investments in EEA and OECD/DTA countries as being "non-equivalent" offshore funds. However, since 1 January 2022 each fund must be analysed on its own merits.

In Tax and Duty Manual 27-01a-03 "Exchange Traded Funds (ETFs)", Revenue state that where this analysis indicates that an ETF held at 1 January 2022 should be treated as an "equivalent" fund, then the 8-year period for a deemed disposal will commence on 1 January 2022 rather than the actual date of acquisition. However, the actual acquisition cost will remain unchanged.

Offshore funds outside EU, EEA or OECD/ DTA countries

Material interests in offshore funds outside the EU, EEA and OECD/ DTA countries are taxed as follows:

- Income distributions to an investor are subject to income tax at the investor's marginal rate (plus PRSI and USC, as relevant);
- Gains arising from the disposal of units by an investor are subject to income tax at the investor's marginal tax rate (plus PRSI and USC, as relevant);
- There is no deemed disposal of the investment every 8 years;
- The investor is deemed to dispose of and reacquire their investment at its market value at the date of his/ her death, which may trigger a taxable deemed gain;
- As these funds are administered outside Ireland, there will be no income tax or CGT deducted at source from income or gains. The investor must account for any tax due on a self-assessment basis;
- Any losses arising on the disposal (or deemed disposal) of units by an investor cannot be offset against other gains;
- Both income and gains can qualify for the remittance basis for non-domiciled investors due to a specific provision from gains from such funds.

Recent Finance Act changes

Earlier this year the Irish Revenue updated Tax and Duty Manual Part 27-02-01 "Offshore Funds: Taxation of Income and Gains from certain offshore states", to reflect amendments introduced in Finance Act 2022 and also Finance Act 2020.

Prior to Finance Act 2022, an interest in certain Irish registered unit trusts was considered an interest in an offshore fund where the trustees are not resident in Ireland. Finance Act 2022 included an amendment whereby Irish unit trusts will not be treated as an offshore fund even if the trustees are resident in another EU or EEA Member State so long as the trustees provide their trustee services to the unit trust through a branch in Ireland and the general administration of the unit trust is ordinarily carried on in Ireland.

Finance Act 2020 clarified the interaction of the offshore fund legislation with respect to the migration of Irish securities from the CREST system to Euroclear Bank in March 2021 following Brexit.

Revenue also updated Tax and Duty Manual Part 27-04-01 "Offshore Funds: Taxation of Income and Gains from EU, EEA and OECD Member States" to provide for a non-exhaustive list of general legal and regulatory criteria that should be considered to assist in establishing whether the threshold of "similar in all material respects" is met, when determining the equivalent nature of an offshore fund to its Irish counterpart.

Final Comment

Tax advisors have been engaging with Revenue in recent years to highlight the need for additional guidance to assist the decision-making process on whether an investment is an offshore fund. Furthermore, advisors are seeking for the taxation of offshore funds regime to be simplified so as to support tax compliance in this area.

Guidance on the appropriate tax treatment of investments is ever evolving, and tax advisers should review it regularly.

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