

# Offshore Funds: Taxation of Income and Gains from certain offshore states

## Part 27-02-01

This document should be read in conjunction with Chapters 2, 3 and 4 of Part 27 TCA 1997, and in conjunction with Tax and Duty Manual (TDM) [Part 27-04-01](#)

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## 1. Introduction to the offshore funds' regime

### 1.1 Background to the regime

Investment income and gains, such as dividends from a foreign company or a profit on the sale of shares in a foreign company, are generally taxed as they arise. That is, dividends are taxed under Income Tax when they are paid and the gain is taxed under Capital Gains Tax (CGT) when it is made.

Prior to the introduction of the 'offshore funds' regime in 1990, an Irish resident investor could defer a liability to Income Tax by allowing an offshore investment to accumulate offshore over a period of years as profits were reinvested. When the investment was eventually realised, the profit element was a capital gain. CGT treatment was more advantageous to the investor than Income Tax treatment as the payment of tax was deferred until the realisation of the investment and a lower rate of tax would often arise.

### 1.2 High level summary of the regime

There are two distinct parts to the offshore funds' regime, depending on where the offshore fund is located:

- (i) Offshore funds located in an EU or EEA state, or in an OECD member with which a double tax agreement has been signed: Tax and Duty Manual (TDM) [Part 27-04-01](#) sets out the taxation of income and gains relating to these offshore funds.
- (ii) Offshore funds located in other territories: This TDM Part 27-02-01 outlines how Irish resident investors are taxed on income and gains from their investment in such offshore funds.

This manual is a summary of the key features of the regime, as it applies to offshore funds in both jurisdictions mentioned in (i) and (ii), as well as the specific rules that apply to offshore funds located outside of the EU, EEA and OECD member states with which we have a double tax agreement, and is not a complete analysis of all aspects thereof.

The taxation of foreign life assurance policies and deferred annuities, which may sometimes be confused with offshore funds, is set out in [TDM Part 19-05-02](#).

There are a number of Decision Trees set out at the end of this manual to help determine whether or not an offshore investment is an investment in an offshore fund.

## 2. When do the 'offshore fund' rules apply?

A person who has a "material interest" in an "offshore fund" will be subject to what is often referred to as the 'offshore fund regime', as outlined below. The tax treatment will depend on whether the fund is a "distributing fund" or not.

### 3. Key definitions

#### 3.1 What is an offshore fund [section 743(1) & (6)]

An interest in any of the following may be an interest in an offshore fund for the purposes of this manual:

- (a) A company resident outside the State (referred to as “overseas companies”);
- (b) A unit trust scheme the trustees of which are resident outside of the State; or
- (c) Any arrangements, other than companies and unit trusts coming within paragraph (a) and (b) above, which take effect by virtue of the law of a territory outside the State, and which create legal rights of a kind with co-ownership. Arrangements which are treated as transparent for tax purposes and where the investor is taxed on the income as it arises, do not come within the offshore funds legislation.

It is important to note that an ‘interest’ is not defined. For example, in relation to a company it is not limited to holding shares in a company.

Where the interest is in a company, unit trust or co-ownership which is established in an EU / EEA Member State, or an OECD member state with which Ireland has a double tax agreement, then regard should be had to [TDM Part 27-04-01](#) for periods from 1 January 2001 onwards.

#### 3.2 What is a material interest [section 743(2), (3) & (4)]

An interest in an offshore fund will be a material interest if, at the time the person acquired it, it would be reasonable to consider that at some time during the next 7 years that person would be able to realise the value of the interest, either by way of transfer, surrender or in any other manner.

It is useful to split having a material interest in an offshore fund into its three component parts:

1. There must be an investment in an offshore fund;
2. That investment **can** be realised within 7 years;

It is important to note that this is an objective test, and not a subjective one. A taxpayer cannot simply say that they did not intend to realise the investment within 7 years: if a secondary market, a grey market or an option to call for redemption exists, or any other mechanism whereby the investment could be expected to be realised, then this test will be met.

Where there is a put / call option in place allowing the investor to either call on other investors or on the offshore fund itself to buy the investment within the 7 year period, this test will be met. The fact that there may be some potential commercial difficulties with realising the value does not, in the absence of any legal or regulatory restrictions, change the fact that it would be reasonable to consider that the investor would be able to realise the value of the investment within 7 years.

**Example**

Catherine owns 1% of a Cayman fund that invests in global equities, which is an offshore fund. For the first 7 years, Catherine has the right to call for a redemption of her investment. However, the Cayman fund has a 10% annual redemption limit, with redemptions carried out on a first come first served basis each year. Would it be reasonable to consider that Catherine will be able to redeem the value of her investment within 7 years?

While Catherine does not have the power to force the fund to redeem her investment, at the date of investment it would not be expected that 70% (10% over 7 years) of the investors would call for a redemption. Therefore, while Catherine may not exercise her power to call for a redemption in year 1 the fact that it would be reasonable to expect that if she did, her investment would be redeemed, means that she would be able to realise her investment and therefore that this is a material interest in an offshore fund.

3. The amount realised is proportionate to the value of the underlying assets in the offshore fund.

Realising the value of an interest means being able to obtain cash, or other assets, which the interest represents in the market value of the net assets of the company, trust or arrangements (section 743(3)). The value of the assets should be taken as the net asset value of the assets of the offshore fund (being the value of the assets less any associated liabilities). The presence of debt within the offshore fund should not impact on whether or not an interest in the offshore fund is a material interest.

Where a person expects to realise more or less than the market value, as will often be the case with quoted shares in a trading company, their holding will not be a material interest. However, if shares in a quoted company generally track the underlying asset values, it may constitute a material interest in an offshore fund. Essentially, if the offshore fund is little more than a “wrapper” for an investment in an underlying asset or assets, an interest in that offshore fund will most likely be a material interest.

**Example 1**

Joan wants to invest in Indian property. Rather than invest directly in the property she decides to buy shares in an Indian company which only holds one asset – the property. The value of the shares in the Indian company will always reflect the value of the property it holds. The property can be described as ‘wrapped’ in the company.

A direct investment in the property would not be an investment in an offshore fund, but the investment via the Indian company is.

**Example 2**

John buys shares in a quoted Indian manufacturing company. The value of the shares is very unlikely to directly track the value of the underlying assets, as they will reflect market sentiment on trading conditions etc.

This is an investment in an offshore fund, but it is not a material interest. The reason is it not a material interest is that it would be reasonable to consider that the value of John's investment will not track the value of the assets within the company.

**3.2.1 Exclusions from being a material interest [section 743(5), (6) & (8)]**

A number of interests in companies, unit trusts or arrangements are specifically excluded by section 743(5) from constituting a 'material interest' as follows:

- (a) Loan capital issued in the ordinary course of a banking business; or
- (b) A right arising under a normal policy of insurance.

Shares held by an Irish company in an overseas trading company are specifically excluded by section 743(6) from being a 'material interest'. This is to ensure that overseas trading ventures are not accidentally brought within the regime. The conditions that must be met for such shares to be excluded are:

- (a) The shares are held by a company for the purposes of its trade, or the trade of another company which is under common control (within the meaning of section 432);
- (b) The shares confer at least 10% of the voting rights and a right to at least 10% of the assets on a winding up of the overseas company;
- (c) The shares of the overseas company are held by 10 or fewer persons and all shares confer both voting rights and a right to assets on a winding up; and
- (d) The shares are voting shares which carry a right to assets on a winding up and they only met the 7 year return of value test when they were acquired by a company because:
  - (i) The company has entered into buy-out arrangements with another shareholder under which the company may sell its shares in the overseas company; or
  - (ii) It is provided that the overseas company will be wound up within a 7 year period.

Interests in an overseas company are specifically excluded by s.743(8) from being a material interest if:

- (a) The person who holds the interest has a right to have the overseas company wound up; and
- (b) On a winding up, the person who holds the interest is entitled to more than 50% of the assets of the company.

**3.3 What is a distributing fund [section 744 and Part 3, Schedule 19]**

The default position is that unless a fund applies to, and is certified by, Revenue, as a distributing fund it is a non-distributing fund.

To secure approval as a distributing fund the fund must apply to Revenue for “distributor” status. The fund has to satisfy a range of conditions for the accounting period in question, one of which is that it distributes at least 85% of its income to its unit holders. A fund is only a distributing fund in respect of an accounting period if it is certified by Revenue as such a fund. A fund must apply to Revenue to be certified as a distributing fund for an accounting period within 6 months of the end of that accounting period.

As the name suggests, a non-distributing fund accumulates rather than distributes its profits to its unit holders from year to year.

#### 4. 3<sup>rd</sup> party reporting [section 896(2)]

Where a person has acted as an intermediary in relation to a material interest in an offshore product, that person has certain reporting obligations. Those reporting obligations, which are set out in s.896(2), are outlined in [TDM Part 38-03-07](#), and failure to correctly return the details carries a penalty of €4,000 per failure.

### 5. Taxation of investors

#### 5.1 Inclusion on a tax return

In the year where a person acquires a material interest in an offshore fund outside of the EU or EEA, or an OECD member state with which Ireland has a double taxation agreement, that person is a chargeable person who must file a Form 11 or Form CT1 as appropriate[s.896(5)]. For those completing a Form 11, Panel E under “other offshore products” should be completed.

Where there is a payment from, or a disposal of an interest in, an offshore fund that amount must be included in the Form 11 or Form CT1, as appropriate.

Income and gains relating to material interests in offshore funds should not be coded against tax credits [refer to [TDM Part 41A-01-01](#) for more details on coding income].

#### 5.2 Distributing Fund

**Income payments** from a distributing offshore fund to an investor who holds a material interest are subject to income tax under the general principles of taxation. Therefore, income arising from foreign securities/ possessions outside the State is taxable under Case III<sup>1</sup>. Income tax, USC and PRSI may therefore all be applicable. These amounts should be declared under “Income from sources not shown elsewhere” (under Panel F on Form 11).

Payments in respect of **disposals** are subject to CGT at a rate of 40% for disposals on or after 12-Feb-1998 [section 747A]. As this payment is liable to CGT rather than income tax, USC and PRSI do not apply. These disposals should be declared at Panel L on Form 11 “Capital Gains” for “Offshore Funds (S. 747A) chargeable at 40%”.

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<sup>1</sup> In accordance with Section 18(2)(e) and (f) TCA 1997

The individual accounts for any tax due under self-assessment.

For the Form CT1, Section 5 “Other Offshore Products” should be completed accordingly.

### 5.3 Non-Distributing Fund

**Income payments** from a non-distributing offshore fund to an investor who holds a material interest are subject to income tax under the general principles of taxation and taxable under Case III. Income Tax, USC and PRSI may therefore all be applicable.

Where a person **disposes** of a material interest in a non-distributing offshore fund, income tax under Case IV will apply [section 745/Schedule 20]. Although these disposals are charged to income tax, gains on disposals of material interest in non-qualifying offshore funds are calculated according to normal CGT rules. However, costs of acquisition will not be indexed for inflation in calculating gains. As this is income determined in accordance with Chapter 2 of Part 27, USC and PRSI apply [as they are not excluded from so applying by section 531AM(1)(b)(iii)(VII)].

Where the computation results in a loss, the disposal is treated as giving rise to neither a gain nor a loss, i.e. losses are ignored [Schedule 20, paragraph 3(2)].

These gains should be declared under “Income from sources not shown elsewhere” (under Panel F on Form 11).

The individual accounts for any tax due under self-assessment.

For the Form CT1, Section 5 “Other Offshore Products” should be completed accordingly.

#### 5.3.1 Death [section 741(3)]

On death, a person who held a material interest in a non-distributing offshore fund is deemed to have disposed of that interest immediately before death for its market value on that date.

#### 5.3.2 Interaction with other offshore provisions

Where in a case both the offshore funds’ regime and the anti-avoidance rules in section 590, section 579, section 579A or section 806 (and associated provisions) apply, section 746 sets out how the two regimes are to interact.

## 6. Practical guidance

Where a taxpayer has invested in an offshore product through an intermediary, the taxpayer should ask the intermediary whether or not they have invested in a material interest in an offshore fund. Given the intermediary’s reporting obligations (refer to part 4 above) they must be in a position to provide this information.



For Revenue officers examining offshore investments, or taxpayers who did not use an intermediary, the only way to correctly identify if an investment is a material interest in an offshore fund is to carefully examine the terms under which it was made. For many, this will mean examining the prospectuses, offering memorandum, financial statements and marketing material regarding the fund structure.

In general terms, an interest in either:

- an open-ended investment fund, or any variable capital company; or
- a close ended investment fund with a predetermined redemption / termination date within 7 years

is likely to constitute a material interest in an offshore fund. However, as with all offshore investments, it is necessary to look at the terms of the investment.

While an investment in an Exchange Traded Fund (ETF) would generally represent a material interest in an offshore fund, investments in Exchange Traded Commodities (ETC) can vary and may be a debt security. If an ETC is a debt security, then it will be taxed in accordance with general taxation principles. A review of the exchange traded product is important to ascertain what tax treatment applies.

Key issues to look out for include:

- Check if there is a wrapper around any underlying investment (refer to Example 1 above).
  - A taxpayer may think that they have invested in property but the investment may really be in a local company which owns the property. In many jurisdictions the preferred method of investing in property is through a local corporate vehicle, which will then be an offshore fund.
  - Foreign property may have been bought jointly with other investors. The exact nature of this should be examined to determine whether or not it is a co-ownership to which the offshore funds' rules apply.
  - Products which track financial markets may be structured as bonds, which are not offshore funds, or they may be structured in a way that is an offshore fund.
  - UK "Individual Savings Accounts", also known as ISAs may be offshore funds. Different ISAs have different structure so it is important to look at the structure of the ISA in question. Some investment ISAs will turn an investment in quoted shares (unlikely to be an offshore fund) into a holding in an investment trust (likely to be an offshore fund).

**It is not the underlying asset which determines the tax treatment, but the nature of the vehicle in which the investment is made, and the terms upon which that investment was made.**

- Statements for Money Market funds often look very similar to deposit account statements. Deposit accounts are not offshore funds while investments in money market funds may be.
- The address on the statement may be a broker's address rather than the address of the offshore fund. A Jersey brokerage address for a Luxembourg fund may make a 'good' location fund look like a 'bad' location fund.

- Synthetic fund products, which aim to mirror the performance of an actual fund, may or may not be offshore funds, the taxpayer should check with their financial advisor as to the composition of the fund.

The following 4 pages contain 4 decision trees, which build upon each other.

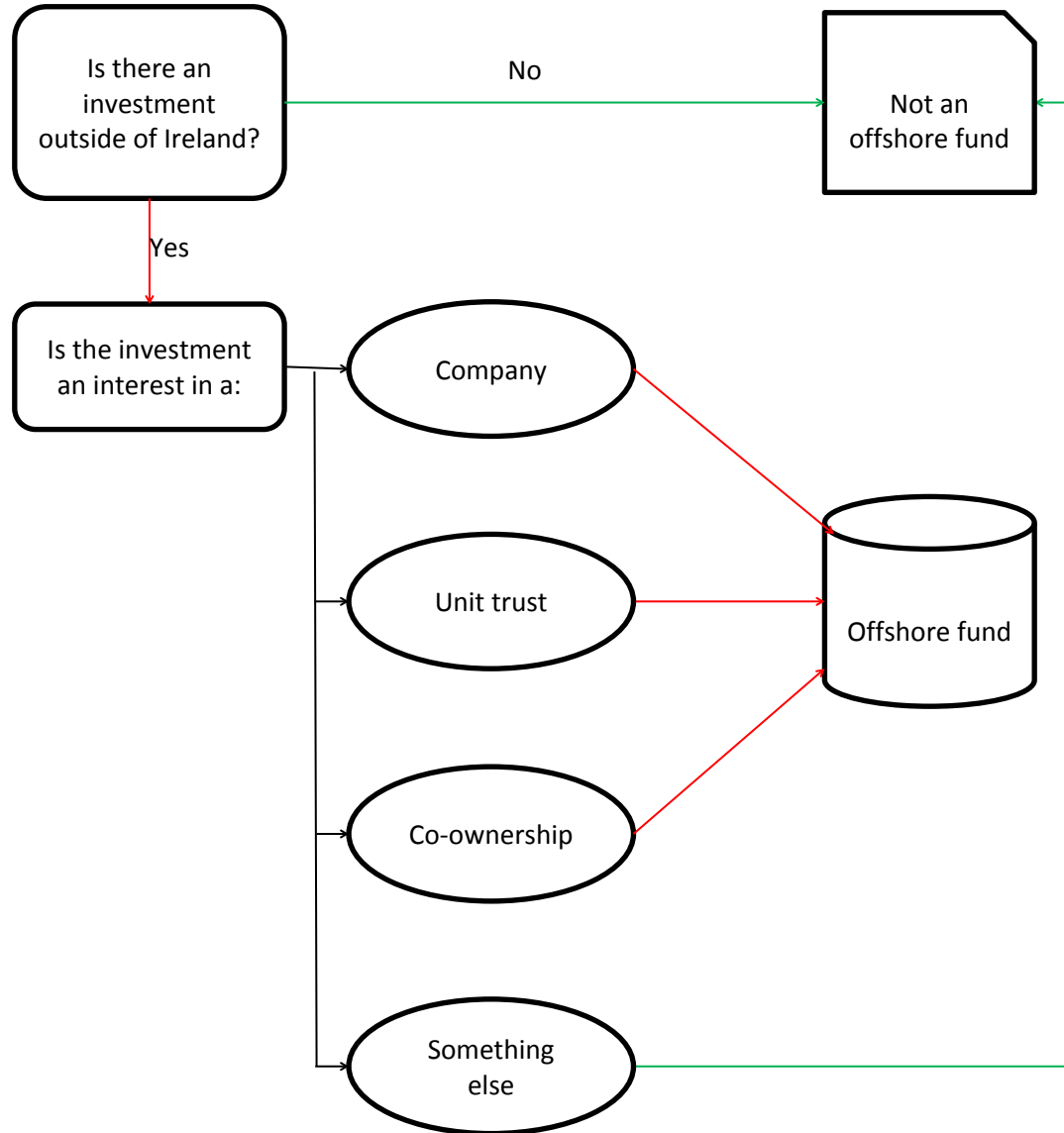
- The first allows you to determine whether or not it is likely that the investment is in an 'offshore fund'.
- The second allows you to determine whether or not the investment is likely to be a 'material interest in an offshore fund'
- The third and fourth are alternatives depending on the nature of the offshore fund, and examine whether the specific exclusions from being a 'material interest in an offshore fund' apply.

## 7. Assistance with decisions on offshore funds

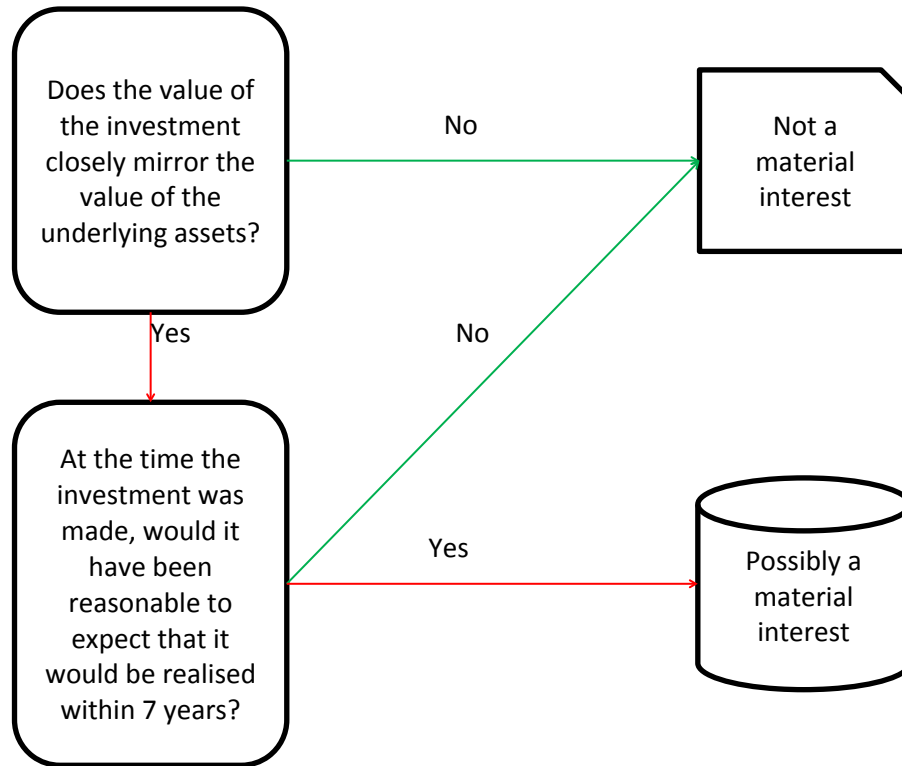
The legislation surrounding offshore funds is complex.

Any taxpayer who believes that they may hold a 'material interest in an offshore fund' on which there is an undeclared tax liability should seek advice from a qualified advisor who has particular expertise in this area.

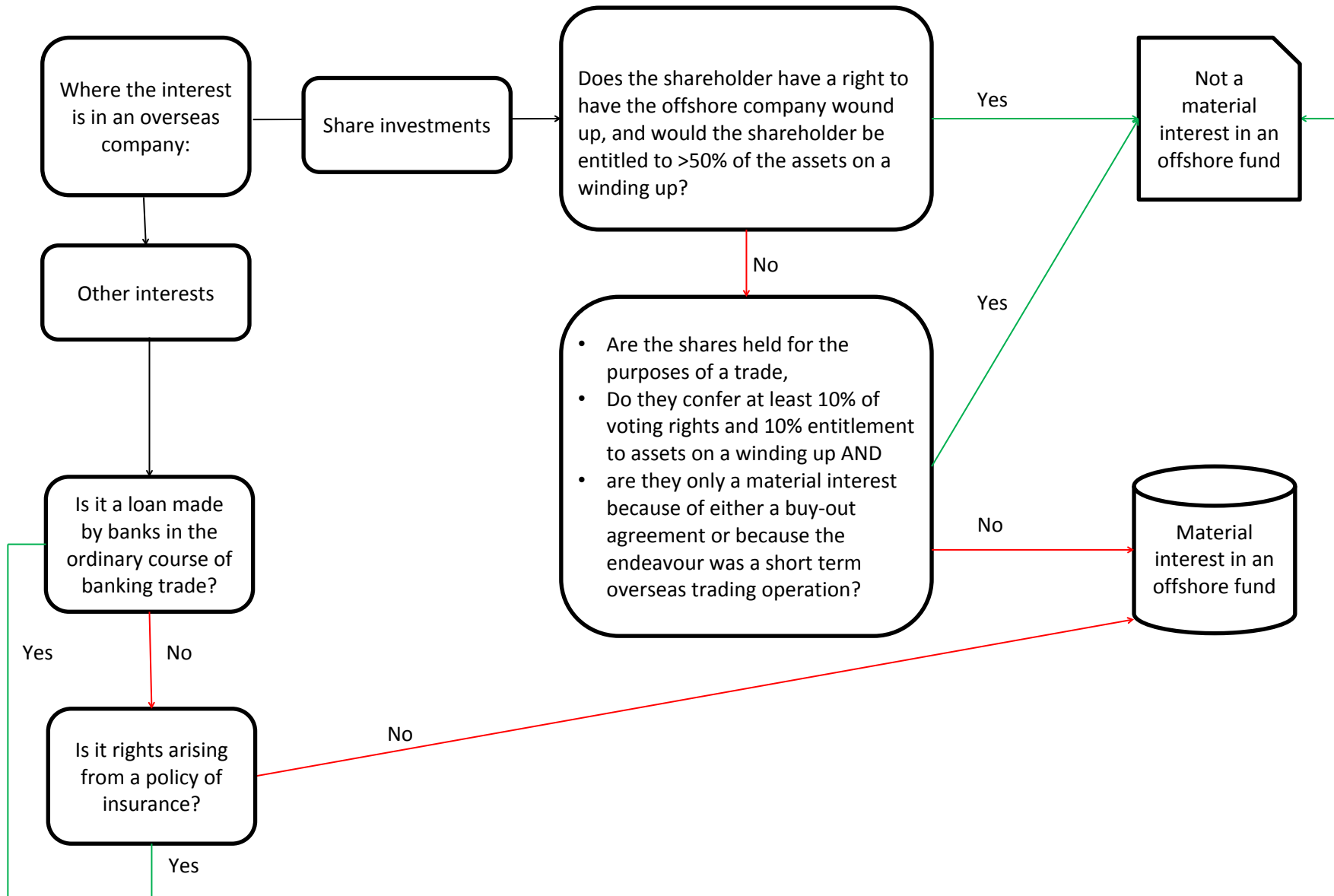
### Decision Tree 1: Is the investment an investment in an 'offshore fund'?



### Decision Tree 2: Does the interest constitute a 'material interest'?



### Decision Tree 3a: Do any of the exclusions apply for investment in an overseas company?



## Decision Tree 3b: Do any of the exclusions apply for investment in other offshore funds?

