THE TAX IMPLICATIONS FOR AUTHORISED INVESTMENT FUNDS FOLLOWING THE NEW FSA REGULATIONS (COLL)

A TECHNICAL DISCUSSION PAPER

Background

1. Following a period of consultation on CP 185, the Financial Services Authority (FSA) have now revised the source book (COLL)[1] setting out the framework for the authorisation and operation of authorised investment funds. The new regulations and guidance contained in COLL came into effect on 1 April 2004.

Taxation of authorised investment funds (AIFs)

2. In summary, authorised unit trusts (AUTs) and open-ended investment companies (OEICs) are treated like companies, but with a corporation tax rate at 20%. On the basis that investors are liable to capital gains tax when disposing of units (or shares in an OEIC), the AIF itself is exempt from tax on capital gains.

3. Distributions from an AIF can be made either as a dividend payment or as an interest distribution. Interest distributions can be made only if the "qualifying investments test" is met. That is, at all times throughout a distribution period the market value of the qualifying investments exceeds 60% of the market value of all investments, in which case interest distributions made are treated as an expense when calculating corporation tax liability. An AIF is deemed to have distributed all the amounts shown in the distribution account as available for distribution.

Context

4. The purpose of this paper is to seek views on a number of technical issues for the taxation of authorised investment funds (AIFs) that might arise from the new FSA regulations. It is seeking views mainly in connection with AUTs and OEICs.

5. The FSA changes permit AIFs to undertake a wider range of investments and investment strategies, and also permit the establishment of a new type of non-retail fund for sophisticated and institutional investors – the Qualifying Investor Scheme (QIS).

6. Although tax was identified as a possible factor in determining the extent to which some of the investment flexibilities now permitted might be taken forward, no specific suggestions for changes were made during the FSA consultation.

7. In considering the need for any possible changes as a result of COLL, it will also be necessary to have regard to other developments in the tax and regulatory environment for investment funds. These include:

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[1] New Collective Investment Scheme Sourcebook Instrument 2004

a. the consultation document on the possible introduction in the UK of a USA style REIT, or Property Investment Fund (PIF) issued by the Treasury;

b. the impact of the introduction of International Accounting Standards (IAS) in the UK, and consequential changes to accounting practices, and

c. the ongoing examination by the Government of the scope for simplifying and modernising the taxation of pooled investment schemes (Budget EFSR[2] paragraph 5.61)

8. Although not directly related to this paper, the PIF consultation document recognises the importance of considering the taxation arrangements for any PIF in the context of the taxation arrangements for existing funds.

9. This paper asks for comments on six main areas:

- The taxation of property rental income within AIFs;
- The impact a wider range of permitted investments might have on the present distribution rules;
- The implications of permitting additional classes of unit holders reflecting different classes of interest;
- Accounting issues, particularly the taxation of derivative strategies, which at present rely heavily on the accounting SORP;
- The treatment of realised capital gains, and if these might be capable of being distributed to investors, and
- The taxation arrangements for the new QIS.

10. More general views for simplification are welcome, in particular on the possibility of having tax rules which apply independently of any regulatory regime i.e. decoupling taxation from regulation.

Taxation of property

Treatment of property rental income

11. Following the introduction of the new rules, AIFs are now permitted to hold 100% of their assets in property, with the opportunity to defer redemption rights by up to 6 months. Previously there was no deferral of redemption rights and the property investment limit was 80%, with a requirement to hold 20% of assets in more liquid form.

12. Currently, rental income is subject to a corporation tax charge of 20% within AIFs. Rental income is distributed as part of any dividend distribution, thus attracting no further tax liability for investors, other than higher rate taxpayers. Rental income is precluded from being part of an interest distribution, and thus carries with it no repayable tax. Although this rate of corporation tax is lower than either basic rate tax - or the

[2] Economic and Fiscal Strategy Report

standard rate of corporation tax - the inability to pass through the tax to investors could mean tax sticking at the fund level for non tax payers.

Might this possibly act as a disincentive to the establishment of funds investing 100% in property?

Might an alternative be to identify property rental separately and stream out in any distribution?

What might be the implications of this for administration?

13. The PIF consultation document seeks views on any potential read across between AIFs and the possible structure of a PIF. Although responses to this technical paper may consider the arguments for changing the present tax treatment for property rental income within the existing distribution rules, consideration of any wider impact or comparisons with a PIF is being taken forward as part of the PIF consultation.

Stamp Duty Land Tax (SDLT) and Stamp Duty Reserve Tax (SDRT)

14. Although not impacted by the new COLL, if it was considered appropriate to make any changes at this time, this review could also be taken as an opportunity to consider any SDLT/ SDRT issues. For example, seeding of AUTs with shares does not attract an SDRT charge because there is no change in beneficial ownership. If an AUT is seeded with land, section 64A Finance Act 2003 entitles the trustee of an AUT to relief from SDLT if certain conditions are met. However, seeding of an OEIC is chargeable to SDLT or SDRT because of the corporate status of the OEIC.

Is this difference a significant issue in practice and, if so, what changes might be appropriate?

Distribution rules

15. Given the wider range of assets in which AIFs can invest, the issue here is the extent to which the present investment test for determining whether or not distributions can be made as an interest distribution should be amended.

16. If the objective is to diversify risk through a spread of assets in a balanced portfolio, it may be harder to meet the test throughout the entire accounting period. Failing the test at any time during the accounting period results in all distributions becoming dividend distributions. As such, the deduction against income for interest distributions is no longer available, and interest income received becomes subject to tax within the fund.

Given the wider range of assets is the test likely to become an issue? If so, what changes might be appropriate?

17. However, might there be an issue to the extent that property as an asset class may make it harder to meet the investment test during an entire accounting period and might payments be complicated by the

introduction of a limited deferral on redemptions? Going further, if property rental income were separately identified, what would be the implications of removing the investment test and allowing distributions to be completely streamed?

Does a particular issue arise in the context of property rental income?

18. As well as considering the distribution rules for retail investors, it has been suggested that consideration be given to extending the corporate streaming rules for dividend distributions to include tax exempt institutional investors such as pension funds and charities. At present dividend distributions to corporate unit holders are split into different elements, identifying separately the element coming from UK dividends (franked) and the element coming from other income (unfranked). There is then no further corporation tax payable on that part of the dividend that is franked, and conversely, any tax suffered in the fund on interest or rental income can pass through to the investor and be set against their tax liability.

If there were greater scope for extending streaming to those corporate unit holders not within the charge to corporation tax, might this facilitate the greater use of AIFs, particularly as a vehicle for investing in property by institutional investors?

19. Equalisation is a mechanism that has featured in the majority of AIFs. Its purpose is to equalise value and ensure that the same distribution could be paid in respect of every unit. It does this by including in the purchase price of new or re-issued units an amount of income accrued up to the date of purchase. The accrued income element is called an "equalisation" amount. In particular the new rules make it possible for investors to buy into, or dispose of, an enhanced income stream late in a distribution period in exchange for a capital sum.

We would welcome views on the impact of the new rules on equalisation and the effect they may have on distributions, in particular how will equalisation of distributions between unit holders be achieved?

20. There may be other potential issues around the whole area of distributions, and any views on wider implications, and the impact on administration, would be appreciated.

Multi classes of unit holders

21. One of the changes permitted by the new COLL is the addition of multi-classes of unit holders within an AUT. This effectively replicates the provision for OEICs where multi-classes of share holders are permitted at present.

22. The tax code flexibility for OEICs to issue different classes of shares is achieved by a modification to Section 468I ICTA 1988, set out in the OEIC regulations SI -1997/1154. In essence, this permits amounts shown as available for distribution to the owners of shares to be made in

respect of different classes of shares, provided that there shall not be any discrimination between the owners of shares.

23. While this covers the position with regards to OEICs, there is no parallel provision to cover multiple classes of units within an AUT.

24. Therefore consideration needs to be given to amendments to the tax code to ensure that there is no discrimination between unit holders having accumulation units and other unit holders (or between unit holders on other grounds).

    Views on what aspects should be taken into account in considering any changes to the tax code for AUTs would be appreciated.

Accounting issues

Derivative / Hedge Fund Strategies

25. The COLL permits a greater range of investment strategies for the QIS, including taking short positions. The present approach to determining the tax treatment for AIFs for loan relationships and derivative contract regimes is set out in Tax Bulletin 60 of 2002 and Schedule 26 to Finance Act 2002.

26. As the use of sophisticated financial instruments may increase, there may be a potential for uncertainty over the application of the present arrangements. In particular, in the context of AIFs, it is understood that there are still uncertainties around how the results of hedge fund type activities should be reflected in the Statement of Total Return, whether as income or capital. This is a technical area relating to the distinction for tax purposes between trading profits and capital gains within this area.

27. The current tax position is broadly that where an AIF has determined the character and treatment of a transaction, providing that is in accord with the relevant accounting standard, it will be followed for tax. However, the wider range of investment activity and choice may create uncertainty in accounting and therefore tax treatment.

    Whether the present divide can be continued in the light of the new opportunities is a matter that needs careful consideration and comments would be appreciated.

28. The issues fall into three broad categories:

    - the ability to create a matched investment through the creation of synthetic assets in such a way as to create a certain position. In effect an income like return is created. (Any investment risk is all but managed away as the nature of the arrangement creates a certain position);

    - the ability for derivatives to be used as the “investment” themselves, rather than as protecting a return achieved by an underlying direct investment (not presently covered in the SORP, but under review by the IMA); and

- the increased use of derivatives and in particular their use other than for efficient portfolio management, including the possibility of short selling and hedge fund type strategies may be perceived to be more like trading rather than investment activity.

29. It is understood that the industry would like to be clearer on how the increased use of derivatives now permitted within AIFs will be regarded by the Revenue. Funds will now be permitted to undertake a wider range of strategies than envisaged at the time the present legislation and SORP were prepared.

    We should be grateful for views on whether or not there is a need to re-examine this whole area and whether new guidance or legislation would be helpful on what activities might be regarded as subject to tax within the fund.

    Alternatively, what assurance can the industry give that the current divide relying as it does on the relevant accounting standard provides adequate protection for the Exchequer in this area to justify continuing divergence from the normal treatment of derivatives afforded to companies.

International Accounting Standards

30. At this stage it is unclear what impact IAS may have on the taxation of AIFs; FB 2004 includes powers to make further regulations if there are difficulties with applying IAS to AIFs within the present tax code. This is particularly important as it is understood that IAS will be applied to all AIFs no later than 1 January 2006. In addition, the Accounting Standards Board has issued a consultative document proposing that IAS 32 and 39 becomes part of UK GAAP on a mandatory basis from 2005 and that AIFs have the option of adopting IAS 39 from that date.

    Any views on the impact of IAS would be appreciated, particularly on the application of the IAS 39 category of “available for sale” assets, and the treatment of investment properties. The issue concerns the extent, and treatment, of what is taken to the distribution account and what is shown as capital.

Capital distributions

31. As a result of the exemption from tax on realised capital gains, the whole of any gain will normally be reflected in an increase in the net asset value of an AIF, with a corresponding increase in the unit value. Investors withdraw their capital by redemption of units, which is then, for most, subjected to capital gains tax.

32. However, unlike Investment Trust Companies, which have a specific prohibition on the distribution as dividends of surpluses from the realisation of investments as part of meeting the condition for their tax treatment, no such specific restriction exists within the tax code for AIFs. Funds will continue to be able to distribute as income only sums properly classed as income and taken to the distribution account under operational guidelines.

33. This links to the possible impact of IAS.

    If, as a result of IAS, it becomes easier to include realised gains in any distribution account, might this then form part of the distribution?

    Might any changes be needed to make clear what the treatment should be?

    Should this include a specific restriction on distribution as income of realised gains from capital items, or capital itself?

Qualified Investor Scheme (QIS)

34. A new category of authorised investment fund - QIS - has been permitted by COLL. This is only available to sophisticated and institutional investors. This new category has a lighter touch regulatory regime and can undertake a much wider range of investment activities, including borrowing and undertaking short positions.

35. As an authorised fund, under the current rules the new QIS falls to be taxed in the same way as any other AIF. This has the advantages of exemption from capital gains within the fund and the lower rate of corporation tax, equal to the savings rate of income tax.

36. The AIF regime was set up originally to provide a clear set of rules for taxing schemes and their investors operating within a tight regulatory framework.

37. Consideration therefore needs to be given to whether a regime designed in the context of a strict regulatory framework should also be applied to a less restrictively regulated QIS scheme; or should it instead be restricted to the more heavily regulated schemes available only to retail investors. The issue is to ensure that the regulatory changes reflected in the new COLL do not have unintended tax consequences and that arrangements designed for the taxation of pooled investments are not open to abuse.

38. The question is whether or not it remains appropriate for this new type of authorised fund to remain within the existing tax code for authorised unit trusts. Is there a case for the tax code applying to authorised products being available only to those products that can be sold to retail investors?

39. We would welcome views on this question. Alternative options might include:

    - Restricting the more favourable tax treatment afforded to authorised unit trusts to retail funds only and then;

    - subjecting QISs to tax in the same way as any ordinary company, or trust.

    - Having some kind of subscription test. For example any authorised fund (including a QIS) that, in practice, had a limited number of unit holders would be excluded from the authorised unit trust regime and

fall to be taxed as an ordinary trust or company outside the AIF regime.

Wider issues

A common tax code for all unit trust schemes?

40. In considering possible changes to the taxation of AIFs, it is also appropriate to consider whether or not it is possible to put in place a single tax code that would cover all unit trust schemes, regardless of their regulatory status. This would have the advantage of decoupling taxation from regulation.

41. The consultation document on PIFs seeks views on the possible impact on unauthorised unit trusts (UUTs) if a PIF is created. UUTs are currently major participants in property investment and it might reasonably be expected that if a PIF is created, depending on the final shape of any PIF, some UUTs might seek to convert. However, it is also understood that some UUTs would not wish to convert to a PIF if this resulted in the valuation of assets being driven by a quoted share price, and not by direct reference to net asset value.

42. While this would be a distinction between a UUT and a possible PIF model, the same need not necessarily be the case if a UUT remained as an unauthorised vehicle, but nonetheless came within the same tax code as an authorised fund.

    If the outcome was the same, what might be the reasons for maintaining a separate UUT regime?

    What role would the existing UUT structure continue to play?

    Would any other changes be needed to the AUT regime in order to facilitate the removal of the separate UUT regime?

43. If consideration were to be given to repealing section 469 ICTA 1988, two alternatives for UUTs might be:

    - to bring UUTs within the same code as AUTs
    - for UUTs to be taxed either under the general rules for trusts or companies.

44. Under the first alternative, instead of the income arising being deemed that of the Trustees, income would be treated in the same way as for AUTs, and taken to a distribution account. Distributions would be either as dividend or interest, and not as annual payments. Capital gains exemption would apply as for AUTs, but without the restriction on the investor base as at present in the UUT arrangement.

    However, before giving further consideration to these options we would appreciate views on the possible implications. In particular, what issues might arise if section 469 ICTA tax code were repealed and what would be the practical implications for UUTs if they were taxed in the same way as AUTs.

45. A possible advantage of a single tax code is that there would be no difference from a tax perspective arising from the status of a unit trust scheme under regulation. However, we are keen to explore whether such an approach might have any adverse impacts on existing UUTs, what these might be and might taxing UUTs in the same way as AUTs open up new possibilities for avoidance. In addition, what safeguards might be needed in order to protect both investors and the Exchequer of such a move if unauthorised schemes were taxed as AUTs, but not be subject to the same degree of regulation?

46. In going forward, the more general question then becomes, what is the role for the UUT regime, and what would be the consequence of its abolition. UUTs might be brought into the authorised funds regime, or alternatively, they may fall within the ordinary tax code applying to Trusts or companies. In considering these options further, specific attention will be given to protection against avoidance.

47. A similar question applies to the code for Pension Funds Pooling Schemes (PFPS). These fully transparent funds for certain limited classes of investor have seen a low take up since introduction. With the introduction of a wider range of investments within AIFs might it be reasonable to expect all PFPSs to convert to AIF status, particularly if the corporate streaming rules were extended? What additional benefits would come from retaining a PFPS regime or what other reasons are there for its continuation?

Conclusion

48. In taking forward the issues covered above, and considering if any amendments are desirable as a result of the new regulations following COLL, the objective is to modernise and - where possible - simplify the taxation of collective investment schemes. In this respect it is important to identify any tax distortions that might arise between similar products. Therefore, as well as views on the issues raised in this paper, any further suggestions for measures to modernise and simplify the taxation of authorised and unauthorised investment funds are welcome.

49. Comments on the issues raised in this paper should be sent by e-mail to: michael.swan@ir.gsi.gov.uk

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