For public comment

PARTIAL REGULATORY IMPACT ASSESSMENT (RIA)

Consolidation of Authorised Investment Funds (AIFs) Taxation

Policy Objective

1. In April 2004 the Financial Services Authority (FSA) introduced a revised regulatory regime for Authorised Investment Funds (Authorised Unit Trusts and Open-ended Investment Companies), which is referred to as the COLL sourcebook. The Government committed to considering whether consequential changes to the tax rules were required.

2. COLL introduced a new type of AIF called a Qualified Investor Scheme (QIS) for sophisticated and institutional investors. One objective is to prevent investors with a substantial holding in a QIS from taking undue advantage of the tax rules for AIFs: special provisions are to be introduced to do this.

3. The present rules for AIFs are split between primary legislation and regulations making them difficult to follow. Another objective is to take the opportunity provided by this post-COLL review to simplify and consolidate so far as practicable the separate sets of rules governing Authorised Unit Trusts (AUTs) and Open-ended Investment Companies (OEICs) in one set of regulations.

4. This opportunity is also being used to make some changes that simplify administration: allowing UK resident individuals who are non taxpayers to receive interest distributions without tax being deducted and formalising and updating in the regulations an Extra Statutory Concession.

Background

5. AIFs are collective investment schemes authorised and regulated by the FSA, which provide the opportunity for investors to pool their assets and have them independently managed on their behalf by professional fund managers. In this way investors spread their risk and gain access to markets and assets that may otherwise be beyond their reach. A special tax regime applies to AIFs and their investors, which is the subject of the draft regulations.

6. The FSA revised, with effect from 1 April 2004, the regulatory rules governing the administration and investment scope of AIFs. The rule changes are contained in their sourcebook, known as COLL and although funds do not have to adopt the new rules until February 2007 they may do so immediately and Qualified Investors Schemes can only be set up under the new rules. Following publication of the new sourcebook, the then Inland Revenue published a technical discussion paper in July 2004 exploring the extent to which tax rules may need amending to facilitate the new arrangements permitted under COLL. The responses to that paper have informed the detail of these proposals. A summary of the responses was published on 25 November 2004 and is available at www.hmrc.gov.uk/pbr2004/suptaximp.pdf.

7. One of the changes made by COLL is the introduction of the "Qualified Investor Scheme" (QIS), which is a non-retail scheme aimed at institutional and sophisticated investors. QIS is less highly regulated, can invest in a wider range of assets – including 100% in property – and can borrow up to 100% of its net asset value. There is therefore a risk that a tax regime designed for widely held retail products that can invest in a limited range of assets could be used by small groups of investors to gain an unintended tax advantage. As the QIS is not a retail scheme, and the QIS itself is subject to the same tax regime as other AIFs, special rules are being introduced to change the tax treatment of certain kinds of investor who own more than a specified percentage of a QIS.

8. In addition to consolidating the existing regimes for AUTs and OEICs into regulations and making changes consequential to the introduction of COLL opportunity is also being taken to adjust the regime as follows:

   - extend the circumstances in which interest distributions can be made gross: funds will be able to pay interest distributions without deduction of tax to individual investors resident in the UK whose income falls below their personal allowance and other reliefs, in the same way as banks and building societies can pay interest gross, saving investors the need to reclaim the tax deducted,

   - bring into legislation, and update, the de minimis rules within what is currently Extra Statutory Concession C30.

9. The first stage of the process was the introduction of primary legislation in Finance Act (No.2) 2005 (F(2)A 2005) to provide powers to consolidate the tax rules for AIFs in regulations. F(2)A 2005 also introduced a new section 468A Income and Corporation Taxes Act 1988 which sets the corporation tax rate for OEICs at the same rate as that for AUTs – the lower rate for income tax (currently 20%).

10. The next step, following Royal Assent of F(2)A 2005, is laying of the regulations to complete the legislative process. Attached to this partial RIA are draft regulations that achieve this.

Rationale for government intervention

11. **Consolidation:** The Government is committed to considering consequential tax changes as a result of the new regulatory regime (COLL), such as rules permitting AUTs to issue multiple classes of units. It also considers that there are significant advantages to be gained from simplifying and rationalising the existing legislation, which has built up piecemeal over many years and which is now considered by many to be unwieldy to navigate, particularly following the introduction OEICs towards the end of the 1990s. The opportunity therefore presented itself to simplify and consolidate the two bodies of legislation (primary and secondary), and to address a number of differences in treatment between an AUT and an OEIC, which, so far as possible, should be dealt with in the same way for tax purposes.

12. The complexity is in part a result of the current regime being written from the point of view of an AUT, with OEICs being brought into these rules using secondary legislation. This makes the legislation cumbersome, difficult to interpret and counter-intuitive. For example, it treats an OEIC, which is a company, as a unit trust, which is a non-corporate body. The AUT's trustees are then treated in the same way as a company for most purposes of the tax rules. With the result that an OEIC is treated in the same way as a company for most purposes of the tax rules.

13. **QIS:** The introduction of QIS, which are subject to the same tax regime as other AIFs, presents opportunities for investors, intent on exploiting the tax rules, to gain unintended tax advantages. These need to be addressed.

14. **Gross Payments:** The existing regimes for distributions that are treated as interest are more restrictive than those dealing with interest paid by bank and building societies in terms of the who can receive interest payments without deduction of tax at source. Allowing more people to register for gross payment of interest distributions will reduce costs for investors and HMRC by eliminating the extra work inherent in people reclaiming tax deducted at source.

15. **Extra Statutory Concession (ESC) C30:** ESC C30 governs some of the tax administration of AIFs when only small amounts are available for distribution. The opportunity is being taken to update and incorporate its effect into the statutory framework.

Consultation

16. In response to COLL, the Inland Revenue published a technical discussion paper on 21 July 2004 to which it received 28 responses. A summary of those responses is on the HMRC website at www.hmrc.gov.uk/pbr2004/suptaximp.pdf.

17. There has also been ongoing discussion with industry representatives on the detail of the proposals. For instance, based on responses to the discussion paper it was intended to introduce a facility to enable AIFs to make both interest and dividend distributions in the same period (currently they make either one or the other). However, as part of discussions with the industry it was concluded that this would be prohibitively expensive for the industry to implement compared with the benefits to investors and is therefore not being introduced.

18. Comments are now invited on the draft regulations and on this partial RIA. Fund Managers are particularly invited to identify specific difficulties they foresee in implementing the regulations and to help identify and quantify associated costs.

Options considered

19. A number of options were considered when deciding how to respond to COLL, many of which were aired in the technical discussion paper. Further refinements have been made after taking account of views expressed in the period between 2004 Pre-Budget report and the passage of Finance (No. 2) Act 2005. The main options are now seen as:

Do nothing

20. Not an option in reality because some changes are made necessary by COLL, both to facilitate the new regime and to prevent opportunities to take undue advantage of the tax rules presented by the introduction of the QIS. In addition Government would have lost the opportunity to consolidate complex legislation into a more easily usable form and investors not liable to tax would have continued to receive interest distributions net of lower rate tax, which they would then have to claim back from HMRC.

Partial consolidation

21. Parts of the package could have been delivered in a number of different combinations. However, this approach would invariably have omitted a number of issues worthy of change and would have missed an opportunity to rationalise the legislation governing the two types of authorised vehicles into a single regime.

Full consolidation

22. Consolidating the existing regimes into a single set of regulations that take account of changes necessitated by COLL, extending reliefs and incorporating concessions and working practices provides all users of the revised rules with a single point of reference. Using regulations allows the rules to adapt quickly and effectively to developments in this fast-moving, internationally mobile industry, whether triggered by product development or future changes to the regulatory environment.

Issues of equity and fairness

23. The package of measures is designed to consolidate the AIF tax regime and to extend it in the areas referred to above. This regime applies equally to all AIFs and those investing in them with the exception of certain investors in the new QIS (where different rules apply to some investors with 10% or more in a QIS). Protection against the effect of this rule will be afforded to those who breach the investment limit through no fault of their own, e.g. if another investor sells their entire holding thereby affecting the percentage of the QIS held by other investors.

Costs and benefits

24. AIFs are an important part of the UK's financial sector, allowing a range of investors access to diversified and professionally managed portfolios. As such they are a vital part of efficient financial intermediation in the UK. AIFs, in total, manage as at the end of October 2005 more than £318bn of assets.

25. The changes will impact on three broad groups:

- Individuals and companies investing in AIFs
- Financial advisers who advise investors on the impact of the new rules, particularly the operation of the element of the consolidated regime applying to some substantial investors in a QIS.
- Investment houses who may need to adjust their processes to accommodate the new rules

Benefits

26. Investors, financial advisers and investment houses will benefit from a simpler, more user-friendly tax regime. This will ease compliance burdens on investors and providers and help reduce costs with the potential for improved returns for investors.

27. Allowing UK resident non-taxpaying individuals to receive interest distributions gross will save administration costs for investors and HMRC. It may make AIFs a more attractive investment for those whose income is below the tax threshold, and encourage those whose income falls below the threshold to retain holdings in such funds rather than switching to other forms of interest bearing investment. It should also result in fewer repayment claims being dealt with by HMRC and advisers.

Costs

28. The administration of the gross payment rules may increase costs for providers as record-keeping requirement will increase and they will have to set up procedures for paying an additional class of investors without deduction of tax. A new HMRC form, similar to that currently used for bank accounts, will be introduced to facilitate administration.

29. Costs may also arise to QIS investors, particularly if their holdings are close to the 10% threshold, as they will need to monitor closely their position.

30. Both AIFs and their investors may have to deal with HMRC enquiries in this area.

Exchequer Impact

31. This is not expected either to raise revenue or cost the Exchequer.

Small Firms Impact Test

32. AIF managers normally fall within the large business sector and we do not believe that there will be any significant impact on small firms. However specific comments are invited on this point.

Competition assessment

33. Simplifying and equalising the tax rules for AUTs and OEICs should help promote greater transparency and competition in the pooled investment industry.

Enforcement, sanctions and monitoring

34. The detail of the proposals has been discussed with industry, which means that representative bodies and their members are aware of the forthcoming changes. Following introduction of the new rules HMRC will publicise the changes on its website and update its guidance as required, particularly in respect of the QIS substantial investor rule. A system will be introduced to monitor the operation of the gross payment of interest distributions. However, no changes will be required to the current Self-Assessment return to accommodate the changes, including the rule applying only to substantial investors in a QIS.

Implementation and delivery plan

35. Following the period of consultation the regulations will be laid before Parliament and subject to an affirmative resolution of Parliament.

36. It is envisaged that the regulations will be implemented from 1 April 2006 (Corporation Tax payers) and 6 April 2006 (Income Tax payers).

Post implementation review

37. HMRC will be reviewing compliance costs as a part of its rolling post-implementation review programme. HMRC will also welcome feedback from the industry on how the new regulations are working.

Annex A

How the QIS substantial holding rule will affect investors

Investors will have an obligation to establish whether their holding in a QIS meets or exceeds 10% of the fund. If it does they must value their holding at each reporting date of the fund (generally twice a year at the time at which investors are notified of distributions). Any increase in that value must be included in their Self Assessment for the tax year in which the fund's reporting date falls. This obligation remains in force until their entire holding has been sold, even if it later falls below the 10% threshold.

If an investor's holding breaches the 10% limit through the action of other investors (for example if other investors dispose of their holdings) then that investor will have a 'period of grace' in which to reduce their holding back below the limit.

These obligations may create demand from QIS investors for information from product providers to enable them to check the status of their investment by reference to the 10% threshold. This will include access to daily unit prices, number of units in the QIS and details of their own holding at the two annual reporting dates.

Two examples to illustrate the above points:

a) Investor A acquires 15% of the value of a QIS.

The 'substantial holding rules' therefore apply until A sells all of the units/shares in that QIS. Each year A will enter any increase in the value of their holding on their Self-Assessment return and pay tax on that amount at their marginal income tax rate. There will not be any capital gain on disposal because all increases in value will have been subject to income tax.

b) Investor B acquires 8% of the value of a QIS in 2004 and makes no further acquisitions. The reporting dates for that fund are 30 June and 31 December. On 31 July 2007 due to a large outflow of funds on the previous day B now holds 12% of the QIS. The information reported to B by the fund manager at 31 December 2007 shows that B now has a substantial holding.

- If B takes action to reduce the holding before the next reporting date, that is before 30 June 2008, then the rule will not apply and B will not be treated as a substantial investor. B will be chargeable in the normal way to Capital Gains Tax on disposal of the holding.

- If B does nothing to remedy the situation then B must calculate the change in the value of the investment from the actual date when the holding first became substantial, that is 31 July 2007 until 31 December 2007. B must then include the amount as miscellaneous income in his or her Self-Assessment for 2007-08. This process must be repeated in each subsequent year (aggregating where there is more than one distribution period ending in the tax year) until the holding is finally disposed of. B must also calculate the capital gain/loss as at 31 July 2007 but will not have to pay any of the tax until the holding is reduced. Once the holding is classified as substantial future changes in value are subject only to income tax.

Note: 'Substantial' is the word used in the draft regulations to describe the holding to which the rules apply. Elsewhere in the Taxes Acts this word has different connotations. To avoid confusion suggestions for alternatives are welcomed.