

Chapter 1: OEICs, unit trusts and offshore funds

Overview

1. This Chapter provides the rules for calculating debits and credits under Part 6 where a company holds an interest in an open-ended investment company (OEIC), unit trust scheme or offshore fund and the assets held by those entities are at least 60% “qualifying investments” by value. Qualifying investments are broadly assets that are or represent loan relationships. Such holdings are treated as rights under a creditor relationship.

2. Holdings by companies in open-ended investment companies (and relevant definitions) were excluded from this Chapter when the Bill was published for consultation in February 2008 because of proposals to amend the Authorised Investment Funds (Tax) Regulations 2006. Following the making of the Authorised Investment Funds (Tax) (Amendment No.2) Regulations 2008 (SI 2008/1463) the application of these provisions to OEICs has now been included.

Clause 1: Overview of Chapter

3. This clause explains what the Chapter does. It is new.

Clause 2: Meaning of “open-ended investment company” etc

4. This clause gives the definition of “open-ended investment company”. The clause is based on paragraph 8(7A), (7B) and (7D) of Schedule 10 to FA 1996 and regulation 95(2) of the Authorised Investment Funds (Tax) Regulations 2006.

5. The definition is by reference to sections 468A(2) to (4) of ICTA because the definition in section 468A(2), read with section 468A(3) and (4), is in substance the same as that in paragraph 8(7A)(b), read with paragraph 8(7B) and (7D) of Schedule 10 to FA 1996 and any differences are negligible.

Clause 3: Meaning of “offshore fund” etc

6. This clause gives a definition of “offshore fund” and also for “a material investment in such a fund” for this Chapter. The clause is based on paragraphs 7(1) and (2) and 8(7F) of Schedule 10 to FA 1996.

7. The definition of “offshore fund” in paragraph 7 of Schedule 10 to FA 1996 has been applied throughout the Chapter. See *Change 64* in Annex 1. Comments were sought on this Change when this Chapter was consulted on in February 2008, and there was no objection to it.

Clause 4: Holdings in OEICs, unit trusts and offshore funds treated as creditor relationship rights

8. This clause provides the basic rule: if at any time in an accounting period an OEIC, unit trust scheme or offshore fund fails the qualifying investments test, a company’s holdings in such entities are treated as rights under a creditor relationship and the credits and debits are to be brought into account on the basis of fair value. The

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clause is based on paragraphs 4(1) to (4) and 7(1) of Schedule 10 to FA 1996, section 48B(5) of FA 2005 and regulation 95(2) of the Authorised Investment Funds (Tax) Regulations 2006.

Clause 5: Holding coming within section 4: opening valuations

9. This clause provides the opening valuation for holdings of an OEIC, unit trust scheme or offshore fund when first acquired. The clause is based on paragraphs 5(1) and 6 of Schedule 10 to FA 1996.

10. The words “the value of that asset” in paragraph 6 of Schedule 10 to FA 1996 have been rewritten as “the value of the holding” since the words in paragraph 6 refer directly back to “valuation of the holding” in sub-paragraph (b) of that paragraph.

11. *Subsection (1)(c)* refers to “the fair value accounting basis” instead of the “market value of the holding” in paragraph 6(1) of that Schedule. This rectifies a missed amendment from FA 2004 which changed references from the latter wording.

Clause 6: Disregard of investments made and liabilities incurred with avoidance intention etc

12. This clause provides that in determining credits and debits to be brought into account by any company in respect of its holding (“the relevant holding”) under the deemed creditor relationship, there shall be left out of account amounts relating to any investment of the collective investment scheme or fund where the investment was made, or any transaction (or series of transactions) relating to the investment was entered into, with a “relevant avoidance intention”. This clause is based on paragraph 4(5) and (6) of Schedule 10 to FA 1996 and regulation 95(2) of the Authorised Investment Funds (Tax) Regulations 2006.

Clause 7: The qualifying investments test

13. This clause explains what is meant by the qualifying investment test and how “qualifying investment” is to be interpreted when applied to OEICs, unit trust schemes or offshore funds. The clause is based on paragraph 8(1), (5), (5A), (7A), and (7C) of Schedule 10 to FA 1996 and regulation 95(3) of the Authorised Investment Funds (Tax) Regulations 2006.

14. Clause 7(2)(b) explains the meaning of references to investments of OEICs for cases where under s.468A(3) of ICTA parts of umbrella companies are themselves regarded as separate OEICs. This involves rewriting the reference in paragraph 8(5A) of Schedule 10 to FA 1996 to “investments comprised in the scheme property of the company” with the changes made by paragraph 8(7B) to (7D) for such parts. Para 8(7C)(a) converts these words to a reference to such of the investments of the umbrella company as form part of the separate pool in question. But for paragraph 8(7C)(a), paragraph 8(7C)(b) would operate on the reference in paragraph 8(5A) to scheme property in the case of such parts, but once paragraph 8(7C)(a) has applied, there are no references to scheme property on which paragraph 8(7C)(b) can operate and so it is otiose and has not been rewritten.

Clause 8: Meaning of “qualifying investments”

15. This clause lists the investments which constitute “qualifying investments”. It is based on paragraph 8(2), (7) and (7E) of Schedule 10 to FA 1996, paragraph 1 of Schedule 2 to FA 2005 and regulation 95(3) of the Authorised Investment Funds (Tax) Regulations 2006.

16. Paragraphs 1 and 9 of Schedule 2 to FA 2005 require the reference to “money placed at interest” in paragraph 8(2)(a) of Schedule 10 to FA 1996 to include a reference to arrangements falling within section 47, 48A, 49 or 49A of FA 2005 (rewritten in Chapter 6 of Part 7). It does not include diminishing shared ownership arrangements under section 47A of FA 2005.

17. The Unit Trust Schemes and Offshore Funds (Non-qualifying Investments Test) Order, SI 2006/981 also added a new paragraph 8(2)(h) to the list of qualifying investments covering “alternative finance arrangements”. They are defined in paragraph 8(7I) of Schedule 10 to FA 1996 by reference to section 46(1) of FA 2005 as arrangements within section 47, 47A, 48A, 49 or 49A of FA 2005.

18. Therefore, diminishing shared ownership arrangements (section 47A of FA 2005) are included as qualifying investments. However, paragraph 8(2)(e) of Schedule 10 to FA 1996 provides that derivative contracts are only included where the underlying subject matter consists of investments within paragraph 8(1)(a) to (d) of Schedule 10 to FA 1996. Therefore derivative contracts that consist mainly of diminishing shared ownership arrangements (section 47A) are not included, and hence the exclusion of these arrangements under *subsection (1)(f)(i)*.

Clause 9: Qualifying holdings

19. This clause explains what is meant by “qualifying holdings” in an OEIC, unit trust scheme or offshore fund within the qualifying investments list in the preceding clause. The clause is based on paragraph 8(3), (4), (6) and (7C) of Schedule 10 to FA 1996.

20. Paragraph 8(3)(b) of Schedule 10 to FA 1996 has been rewritten to make it clear that “the same accounting period” refers to the accounting period of the company holding the investment in the unit trust scheme etc and not the accounting period of the unit trust scheme etc.

21. Paragraphs 8(6A) and (6B) of that Schedule have not been rewritten because they are considered unnecessary and add nothing to the operation of paragraph 8(6)(c). It does not matter for the purposes of paragraph 8(6)(c) whether the shares are of different denominations; all that matters is their value.

Clause 10: Meaning of “hedging relationship”

22. This clause provides the meaning of “hedging relationship” for this Chapter. It is based on paragraphs 8(7E), (7G) and (7H) of Schedule 10 to FA 1996.

Clause 11: Power to change investments that are qualifying investments

23. This clause gives the Treasury power to amend this Chapter. The clause is based on paragraphs 8(8) and 9 of Schedule 10 to FA 1996.

24. *Subsection (1)* includes a change that allows the Treasury to amend the descriptions of qualifying investments of an open-ended investment company. See *Change 378* in Annex 1.

<p>Q1. We welcome comments on extending the Treasury's order making power so that amendments can be made to the list of qualifying investments not just for investments of unit trust schemes and offshore funds, but also for OEICs.</p>
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25. *Subsection (2)* allows orders to be made for “such incidental, supplemental, consequential and transitional provision and savings”. This is a standard formulation for Bill 5 for the extra things that can be done under an order- and regulation-making powers. It is not considered a change in the law.

Change 64: Relationships treated as loan relationships etc: definition of offshore funds for qualifying investments test: clauses 3, 7 and 561

This change clarifies the meaning of “offshore fund” in paragraphs 4 and 8 of Schedule 10 to FA 1996 for the purposes of the “non-qualifying investments test” (known as the “qualifying investments test” in Part 7 (relationships treated as loan relationships etc)).

Paragraph 4 of Schedule 10 to FA 1996 provides for a company’s “relevant interest in an offshore fund” to be treated as a right under a creditor relationship where the fund fails to satisfy the non-qualifying investments test: broadly where more than 60% of the holdings of the fund by value represent investments that would be loan relationships if held directly by the company.

“Offshore fund” is not directly defined for the purposes of paragraph 4 of Schedule 10 to FA 1996, but the meaning of “relevant interest in an offshore fund” for the purposes of paragraph 4 is given by paragraph 7 of the same Schedule. It is defined as a material interest in an offshore fund for the purposes of Chapter 5 of Part 17 of ICTA *or an interest which would be such an interest on the assumption that the unit trust schemes and arrangements referred to in section 756A(1)(b) and (c) of ICTA were not limited to collective investment schemes*. Section 756A(1) of ICTA (which is subject to sections 756B and 756C of that Act), gives the meaning of “offshore fund” for the purposes of Chapter 5 of Part 17 of ICTA and requires that offshore funds should be collective investment schemes. But the definition of “relevant interest in an offshore fund” in paragraph 7 extends that meaning.

The “non-qualifying investments test” referred to in paragraph 4(1) is in paragraph 8 of Schedule 10 to FA 1996. Paragraph 8(7F) requires “offshore fund”, for the purpose of the test, to have the same meaning as in Chapter 5 of Part 17 of ICTA, but it does not mention the assumption in paragraph 7(1)(b) of Schedule 10 that unit trust schemes and arrangements referred to in section 756A(1)(b) and (c) of ICTA need not be limited to collective investment schemes. So it is unclear if that extension to non-collective investment schemes applies.

The definition in paragraph 8(7F) applies to offshore funds held by the investing company, that is, the same offshore fund and the same company as are referred to in paragraph 4(1) (to which the definition in paragraph 7 refers) since the definition in paragraph 8(7F) also applies for the interpretation of “assets of an offshore fund”. That expression occurs in paragraph 8(5)(b), which in turn gives the meaning of “investments of an offshore fund” for the purposes of paragraph 8(1) (“investments of the ... fund”). This is the same offshore fund referred to in paragraph 4(1).

Paragraph 7(1)(b) and (2) of Schedule 10 provides that for the purposes of paragraph 4 of Schedule 10 an interest is a “relevant interest in an offshore fund” (and therefore falls within paragraph 4(1)(a)) if it would be a “material interest in an offshore fund” assuming the arrangements in section 756A(1)(b) and (c) of ICTA were not limited to

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collective investment schemes. Therefore it appears that the clear legislative intent was that such interests are subject to paragraph 4 if the fund “fails to satisfy the non-qualifying investments test” in paragraph 4(1)(b), so that the debits and credits brought into account for the purposes of corporation tax as respects the company’s interest in the fund are determined on the basis of fair value accounting.

If, when FA 2004 added paragraph 8(7F) to Schedule 10, the intention had been that the narrow definition in paragraph 8(7F) was to apply without the extension implied by paragraph 7(1)(b) and (2) and so that extension was to be ineffective, FA 2004 would have repealed paragraph 7(1)(b) and (2), and there would have been mention of this intention in the commentary to the Finance Bill 2004. So it appears that the better interpretation is that the wider definition of an offshore fund given by the application of the assumption in paragraph 7(2) was meant to apply throughout and therefore it is applied by clause 3 for the whole of Chapter 3 of Part 7 and the definition of assets of an offshore fund in clause 7 is glossed accordingly.

Clause 561 in Part 8 (derivative contracts) refers also to a holding that is “a material interest in an offshore fund” and applies the meaning of that phrase in clause 3. This change therefore applies also for the purposes of that clause.

This is a minor change in the law as it will prevent the taxpayer from arguing the contrary view that the assumption in paragraph 7(2) does not apply.

Adopting the wider definition of what is an offshore fund potentially brings more investments within the possibility of being qualifying investments and therefore makes it more probable that holdings in the unit trust or offshore fund with the investments are subject to the loan relationship provisions. Whether being subject to the loan relationship provisions is adverse or beneficial depends on the circumstances of the taxpayer.

This change is in principle adverse to some taxpayers and favourable to others. But it is in line with the original legislation before amendment and with the intention of the amended legislation.

Change 378: Relationships treated as loan relationships etc: power to change investments that are qualifying investments: clause 11

This change extends the power in paragraph 8(8) of Schedule 10 to FA 1996 for the Treasury to amend paragraph 8 of that Schedule to extend or restrict the investments of a unit trust scheme or offshore fund that are qualifying investments, so that it also covers investments of open-ended investment companies (“OEICs”).

Paragraph 4 of Schedule 10 to FA 1996 treats a company’s holdings in unit trust schemes or offshore funds as rights under a loan relationship of the company if the schemes or funds fail the test set out in paragraph 8 of that Schedule. The test is failed when the market value of the scheme’s or fund’s “qualifying investments”

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exceeds 60% of the market value of all its investments. Paragraphs 4 and 8 of Schedule 10 are modified by regulation 95 of the Authorised Investment Funds (Tax) Regulations 2006 (S.I. 2006/964) so that they apply similarly to holdings in OEICs.

However, paragraph 8(8) of Schedule 10 only gives power for paragraph 8 to be amended by order so as to extend or restrict the investments of unit trust schemes or offshore funds that are qualifying investments, not those of OEICs. Although a similar effect might be achieved using the regulation-making power in section 17(3) of F(No.2)A 2005 to modify paragraph 8 in relation to OEICs.

Chapter 3 of Part 7 of the Bill rewrites Schedule 10, incorporating the modifications relating to OEICs. In rewriting paragraph 8(8) in clause 11, the opportunity has been taken to extend the power in that paragraph to cover investments of OEICs, as well as unit trust funds and offshore funds, so that so a single instrument can be used to extend or restrict the qualifying investments of all three investment vehicles.

Extending or restricting the investments of OEICs that are qualifying investments could be beneficial or adverse to a company with holdings in OEICs. But since the same effect could be obtained by making regulations under section 17(3) of F(No.2)A 2005, the change does not extend the overall scope of the Treasury's powers.

This change has no implications for the amount of tax paid, who pays it or when. It affects only administrative matters.