

# **Tax Law Rewrite**

## **Response to Paper CC/SC (09) 08**

### **Investment Trusts**

This document is available on the internet at:

<http://www.hmrc.gov.uk/rewrite>

2 October 2009

#### **Introduction**

1. We published Committee Paper CC/SC (09) 08 on 12 May 2009 on the HMRC internet website [www.hmrc.gov.uk/rewrite](http://www.hmrc.gov.uk/rewrite). The closing date for responses was 31 July 2009. The draft clauses rewrite section 842 of ICTA and provide the rules covering the approval of a company as an investment trust by the Commissioners for HMRC.
2. The purpose of this response document is to provide details of the substantive points made and to explain our analysis and proposals in respect of them. Minor points such as suggestions to improve punctuation are not covered, but all comments received have been carefully considered.
3. We received written responses from the following:
  - The Institute of Chartered Accountants in England and Wales
  - KPMG and
  - The Association of Investment Companies.
4. We are very grateful for all the comments made, many of which were detailed and we appreciate the time and effort that went into them. We have sent each respondent a copy of this response document.
5. Two minor changes were proposed in the Committee Papers. Responses to these are noted below.
6. The latest clauses are attached. References to the clauses in this response document show both the numbers of the clauses attached to the Committee papers in May and the clause numbers in the latest published version of Bill 6 in September this year.

## General

7. The general view was that the clauses are well-drafted and clear and an improvement on the source legislation.

8. Some suggestions were made on policy matters.

*We note that there is no definition of the word “securities”. As stated in our response to the **Investment Trust Companies: next steps** paper (see our response dated 11 February 2009), we understand that Revenue & Customs have previously agreed with the AIC that the definition in s132(3)(b) of the Taxation of Chargeable Gains Act 1992 will apply. This definition provides that “security” includes any loan stock or similar security whether of the Government of the United Kingdom or of any other government, or of any public or local authority in the United Kingdom or elsewhere, or of any company, and whether secured or unsecured.*

*The interpretation of this section has proven to be a difficult issue in the past. For example:*

- *Are the items said to be “included” an exhaustive list or merely illustrative?*
- *What makes “loan” into “loan stock”?*
- *How “similar” does the “similar security” have to be?*
- *The definition is partly circular, using the word “security” to define “security”.*

*In our experience, a number of UK ITCs have taken a conservative approach when determining which non-equity investments to hold to ensure that they will pass the income test without including income from investments which do not clearly fit within the somewhat unclear wording of the definition.*

*As is intended by the Government, the new framework for ITCs to stream their distributions (SI 2009/2034) will provide a method for UK ITCs to invest in bonds, and other assets producing an income-like return, without suffering tax on that income.*

*In our view, however, unless a corresponding change is made to the income test, ITCs investing in such assets may be at risk of losing ITC status, and so risk suffering tax on capital returns, which would undermine the aim of the new framework. UK ITCs would not in practice have the intended flexibility to invest in the non-equity assets they consider will provide the best returns for their investors. At the same time non-UK investment companies and AIF bond funds will continue to enjoy this flexibility.*

*Thus, if UK ITCs are to be free to invest a larger proportion of their portfolio in different types of securities, the interpretation of the term “securities” will*

*become crucial to ensure that they have certainty in the treatment of those securities in relation to s842.*

**9. *This suggestion is outside the remit of this project but has been passed to our policy colleagues for consideration.***

*Our view is that the Government should consider issuing legislation allowing for the possibility of ITCs making “inadvertent breaches” of the requirements, akin to the legislation in respect of venture capital trusts (SI 2008/1893).*

**10. *This suggestion is outside the remit of this project but has been passed to our policy colleagues for consideration.***

**Clause 1/1157: Meaning of investment trust**

11. The respondents approved of the clause making it explicit that the requirement that the company is not a close company relates to the whole accounting period for which approval is sought.

**Clause 2/1158: Conditions for approval**

12. The respondents also welcomed the clarification that conditions A, B and E apply to the whole accounting period.

13. Two respondents suggested that we retain the reference to the investing company’s investments in condition E and noted that use of this phrase would also be helpful in clause 5/1161.

**14. We agree and the clauses have been amended.**

15. We also received a suggestion on policy matters.

*As you will be aware, existing practice is that Revenue & Customs continues to include franked investment income received by an investment trust when considering sections 842(1)(a) and (e). We ask that this opportunity is taken to include an additional paragraph within this clause so that the approach is now confirmed in statute, and that this approach will also be taken in relation to non-UK dividends following the new dividend exemption provisions. If these points are not covered in the rewritten legislation then at the very least we would request that written guidance on them is issued by Revenue & Customs.*

*We also request that Revenue & Customs confirms, ideally in legislation or, failing that, in guidance:*

- that the 10% tax credit attaching to dividends should be included for these purposes; and*
- that dividends should be brought into account for these purposes on a receipts basis.*

16. *This suggestion is outside the remit of this project but has been passed to our policy colleagues for consideration.*

**Clause 4/1160: The income retention condition: exceptions**

*We consider that the de minimis amount of £10,000 in clause 4(1)(a) and (2)(b)(ii) should be increased to reflect increases in the RPI since 1990 when it was introduced to s842 ICTA.*

17. *This suggestion is outside the remit of this project but has been passed to our policy colleagues for consideration.*

**Clause 7/1163: More about the meaning of “holding in a company”**

18. One respondent suggested that we add the words “other than the shares or securities of the second company” in clause 7/1163(1)(c).

19. We agree that there would be merit in making the clarification but the change is not within the scope of the project. This point will therefore be referred to policy colleagues for further consideration.

20. *We have referred this question to policy colleagues*

*Q1 We welcome comments on the rewrite of section 842(2D) and (3A) of ICTA*

21. Respondents were content with the rewrite of these provisions in clause 3/2758.

*Q2 We welcome comments on the provision that deals with the disposal of shares or securities from a holding in relation to condition E*

22. Respondents were content with the rewrite of the HMRC practice on the disposal of shares and securities. Suggestions were made to clarify the wording and effect of this provision.

*In principle, we welcome the introduction of clause 5(4). We assume the intention is that where there is a disposal which leaves a holding of less than 15%, that holding is treated as continuing to be less than 15% from the date of the disposal. Expressly stating this in the legislation would remove any doubt that the clause, as currently drafted, implied that an addition, which caused a breach of the 15% test, may not cause loss of status, if a suitable disposal is subsequently made.*

23. *We agree and the revised wording of clause 5/1151(4) and (5) makes it clear that the holding is treated as representing 15% or less by value of the investing company’s investments in accounting periods later than the period when the disposal was made.*

24. Another commentator considered the wording of the clause and the other responses:

*With regard to the concession you refer to, I can confirm that it is only intended to enable a company to regain investment trust status in a subsequent*

*period, without having to sell down below 15% and then acquire an additional small tranche of shares/securities to trigger an addition. It is not intended to enable a company to obtain investment trust on a breach of the 15% holding limit by selling down before the year end. I am therefore happy to clarify this point in the rewrite, but am not sure that saying the test was met "from the date of the disposal" is sufficient. This is because, if the holding goes through the 15% limit in the next accounting period, but due to market fluctuations, then the holding at the point of the most recent enlargement would also be above 15%, so status would be lost again. What I think it may need to say is that, at the date of the disposal, the holding is treated as if it were holding that has just been acquired or enlarged.*

***25. The wording of clause 5/1161(4) and (5) has been revised to reflect the terms of the existing concession in the Company Tax Manual more closely. There is the point already noted about the effect on subsequent accounting periods (this is set out in subsection (5)). In addition subsection (4)(b) provides that subsection (5) applies in a case where before the disposal the holding exceeded 15% by value. Finally in subsection (5) it is made clear that this provision has effect if the holding does not already fall to be treated as representing 15% or less of the investing company's investment under clause 1161(3).***

# Draft Corporation Tax Bill

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## PART 1

### CORPORATION TAX ACTS DEFINITIONS ETC

#### CHAPTER 1

##### INVESTMENT TRUSTS

#### **1157 Meaning of “investment trust” [j2750]**

In the Corporation Tax Acts “investment trust”, with respect to an accounting period, means a company which –

- (a) is approved for the purposes of this Chapter for that period by the Commissioners for Her Majesty’s Revenue and Customs, and
- (b) is not a close company at any time in that period.

Origin: ICTA s.842(1).

#### **1158 Conditions for approval [j2751]**

- (1) The Commissioners for Her Majesty’s Revenue and Customs must not approve a company under section 1157 for an accounting period unless it is shown to their satisfaction that each of conditions A to F is met.

##### *Condition A*

The company must be UK resident throughout the accounting period.

##### *Condition B*

The shares making up the company’s ordinary share capital (or if they are of more than one class, those of each class) must be included in the official UK list throughout the accounting period.

##### *Condition C*

The company’s income of the accounting period must be derived wholly or mainly from shares or securities.

##### *Condition D*

The company must not retain in respect of the accounting period an amount which is greater than 15% of the income it derives from shares or securities (but see section 1160).

##### *Condition E*

The company must not at any time in the accounting period have a holding in a company that represents more than 15% by value of the investing company’s investments (but see section 1161).

*Condition F*

The company's memorandum or articles of association must prohibit the distribution as dividend of surpluses arising from the realisation of investments.

**Origin:** ICTA s.842(1).

- (2) The conditions lettered A to F in subsection (1) are referred to by those letters in this Chapter.

**Origin:** Drafting.

**1159 Calculation of income [j2758]**

- (1) Subsections (2) to (4) apply in determining, for the purposes of condition C or D (and accordingly of section 1160(2)(a)), with respect to any accounting period of a company –
- (a) the amount of a company's income, or
  - (b) the amount of income which a company derives from shares or securities.

**Origin:** ICTA s.842(1AB), (2D), (3A); drafting.

- (2) The amounts to be brought into account under Part 5 of CTA 2009 in respect of the company's loan relationships are to be determined without reference to any debtor relationships of the company.

**Origin:** ICTA s.842(1AB).

- (3) The excess of –
- (a) any credits brought into account in respect of the accounting period by virtue of section 574 of CTA 2009 (non-trading credits in respect of derivative contracts), over
  - (b) any debits brought into account in respect of the accounting period by virtue of that section (non-trading debits in respect of derivative contracts),

is to be treated as income of the period which is derived from shares or securities.

**Origin:** ICTA s.842(2D), (2E).

- (4) Income treated as arising under [regulation 18(1)] of the Offshore Funds (Tax) Regulations 2009 is to be ignored.

**Origin:** ICTA s.842(3A).

- (5) In determining the amount of a company's income for the purposes of condition C, no account is to be taken of any amount treated under section 1229(3)(b) of CTA 2009 (claw back of relief for expenses of management) as a receipt chargeable under the charge to corporation tax on income.

**Origin:** ICTA s.842(1AC).

**1160 The income retention condition: exceptions [j2756]**

- (1) Condition D does not apply in relation to an accounting period if the amount that the company would be required to distribute in order to meet the condition is less than –

- (a) £10,000, or
- (b) if the period is shorter than 12 months, a proportionately reduced amount.

Origin: ICTA s.842(2C).

- (2) Condition D does not apply in relation to an accounting period if –
  - (a) by virtue of a restriction imposed by law, the company is required to retain in respect of the period an amount of income that exceeds 15% of the income the company derives from shares and securities, and
  - (b) either –
    - (i) the amount of income that the company retains in respect of the accounting period does not exceed the amount of income that it is required to retain in respect of the period by virtue of a restriction imposed by law, or
    - (ii) if there is such an excess, the amount of the excess plus the amount of any income that the company distributes in respect of the period is less than £10,000.

Origin: ICTA s.842(2A), (2B).

- (3) If the accounting period mentioned in subsection (2) is shorter than 12 months, the amount of £10,000 mentioned in subsection (2)(b)(ii) is proportionately reduced.

Origin: ICTA s.842(2B).

#### 1161 The 15% holding limit: exceptions [j2752]

- (1) In condition E the reference to a holding in a company does not include a holding in –
  - (a) an investment trust, or
  - (b) a company that would qualify as an investment trust but for condition B (listing in the official UK list).

Origin: ICTA s.842(1).

- (2) Subsection (3) applies if a company has a holding in a company and immediately after –
  - (a) the time when the holding was acquired (if it has not been enlarged), or
  - (b) the most recent time when the holding was enlarged,the holding represented 15% or less by value of the investing company's investments.

Origin: ICTA s.842(2), (3).

- (3) For the purposes of condition E the holding is treated as continuing to represent 15% or less by value of the investing company's investments until the holding is next enlarged.

Origin: ICTA s.842(2).

- (4) Subsection (5) applies if –
  - (a) a company disposes of shares or securities from a holding it has in a company,
  - (b) immediately before the disposal the holding represents more than 15% by value of the investing company's investments, and

- (c) immediately after the disposal the holding represents 15% or less by value of the investing company's investments.

Origin: Annex 1, Change [jc684].

- (5) For the purpose of determining whether the investing company meets condition E in accounting periods later than that in which the disposal was made, the holding is treated (if it does not already fall to be so treated under subsection (3)) as continuing to represent 15% or less by value of the investing company's investments until the holding is next enlarged.

Origin: Annex 1, Change [jc684].

- (6) If a holding which a company has in another company –
  - (a) was acquired before 6 April 1965, and
  - (b) on 6 April 1965 represented 25% or less by value of the investing company's investments,condition E does not apply to the holding so long as it is not enlarged.

Origin: ICTA s.842(2).

#### **1162 Basic meaning of “holding in a company” [j2759]**

- (1) In this Chapter “holding in a company” means the shares or securities (whether of one class or more than one class) held in any one company.

Origin: ICTA s.842(3).

- (2) For the purposes of section 1161 a holding in a company is enlarged whenever the company whose holding it is –
  - (a) acquires further shares or securities of the company, but
  - (b) does not do so by being allotted shares or securities without becoming liable to give any consideration.

Origin: ICTA s.842(3).

#### **1163 More about the meaning of “holding in a company” [j2753]**

- (1) Subsection (2) applies if, in connection with a scheme of reconstruction –
  - (a) a company issues shares or securities,
  - (b) the shares or securities are issued to persons holding shares or securities in a second company in respect of and in proportion to (or as nearly as may be in proportion to) their holdings in the second company, and
  - (c) those persons do not become liable to give any consideration for the shares or securities.

Origin: ICTA s.842(3).

- (2) For the purposes of this Chapter-
  - (a) a holding of the shares or securities of the second company, and
  - (b) a corresponding holding of the shares or securities issued by the first company,are to be regarded as the same holding.

Origin: ICTA s.842(3).

- (3) For the purposes of this Chapter, holdings in two or more companies which are members of the same group are treated as holdings in a single company.

Origin: ICTA s.842(1A).

- (4) Subsection (3) does not apply to a holding in—
- (a) an investment trust, or
  - (b) a company that would qualify as an investment trust but for condition B (listing in the official UK list).

Origin: ICTA s.842(1A).

- (5) For the purposes of subsection (3) it does not matter whether or not the group is one that includes the company which has the holdings.

Origin: ICTA s.842(1A).

- (6) If a company (“company A”) is a member of a group, money owed to it by another member of the group is treated, for the purpose of determining whether condition E is met—
- (a) as a security of the latter held by company A, and
  - (b) accordingly as, or as part of, the holding of company A in the company owing the money.

Origin: ICTA s.842(1A).

- (7) In this section “group” means a company and all its 51% subsidiaries.

Origin: ICTA s.842(4).

#### 1164 Other interpretation [j2754]

- (1) In this Chapter “company” has the meaning given by section [j4996] and is to be read in accordance with section 99 of TCGA 1992 (application of that Act to unit trust schemes).

Origin: ICTA s.842(4).

- (2) In this Chapter “scheme of reconstruction” has the same meaning as in section 136 of TCGA 1992.

Origin: ICTA s.842(4).

- (3) In this Chapter “shares” includes stock and is to be read in accordance with section 99 of TCGA 1992.

Origin: ICTA s.842(4).