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Stamp Duty Reserve Tax on Collective Investment Schemes: Exemption for investments in underlying schemes

Schedule 19 of the Finance Act 1999 ('Schedule 19') contains the special Stamp Duty Reserve Tax ('SDRT') regime for collective investment schemes. Section 84 of the Finance Act 2011 enacted a change to the circumstances in which interests in underlying schemes are classed as exempt for the purposes of Schedule 19. In the future, such interests will be exempt if both:

- (i) the underlying scheme is a collective investment scheme as defined in the Financial Services and Markets Act 2000; and
- (ii) the value of the underlying scheme's non-exempt investments is no more than 20 per cent of the value of its total investments.

Practicalities

Self-certification – as is the case now, fund managers will need to sign the notice confirming that their investments are either exempt or non-exempt for Schedule 19 purposes. This change allows them additionally to categorise investments meeting the above two conditions as exempt.

Cash – cash which is held for the day-to-day management of a collective investment scheme is not an investment and therefore should not be included in any calculation of whether the 20 per cent limit is met. However, cash holdings which do form part of the investments of the scheme should be included in the calculation. It is best practice to hold cash held for day-to-day management separately from any cash investments.

Evidence – managers first need to satisfy themselves that the interests they hold are exempt. If they are unable to do this, then they should classify the interests as part of their non-exempt investments. Later, the manager could be asked to provide evidence to HMRC that the interest in the underlying scheme did indeed qualify as an exempt investment by meeting the two conditions outlined above. Historic evidence may be used (although at the time that it is being used it should be as far as practical the most recently available version) as long as there is no indication that it has become unreliable or that circumstances have changed. As evidence ages, fund managers will have to be less confident over its reliability.

Acceptable evidence which could be viewed as providing a reasonable basis for deciding that an investment is exempt, and as acceptable evidence to HMRC, might include the following:

- the underlying scheme is listed by a reliable source which indicates that it fulfils the above two conditions. For example, inclusion in a sector classification scheme such as the Investment Management Association sectors, or sectors provided by commercial data providers, where individual sector definitions would require a fund to have no more than 20 per cent of its holdings in non-exempt investments¹;
- information about the composition of a scheme from the investment policy laid down in a scheme's rules or instrument of incorporation; or
- other reliable sources of information such as the underlying scheme's accounts, a fund's factsheet, or information from the custodian or administrator.

The name of a collective investment scheme is not conclusive evidence as to what type of investments it holds. However, some regulators restrict what schemes can be called. For example, in the UK an authorised fund must not have a misleading name². Where the name of a scheme, in the context of its local regulatory environment, implies that it meets the requirements of the exemption then this may be used as evidence by a fund manager. However, this should be treated as one piece of evidence which will normally require additional validation unless, given the relevant regulatory environment, it is very clear that the scheme must meet the requirements of the exemption.

For example, HMRC accepts that holdings in a collective investment scheme authorised within the EU that has the words "money market fund" in its title, can be treated as exempt since (amongst other things) it is prohibited from investing in equities, including UK equities³.

¹ E.g. the Japanese or North American sectors into which only funds holding at least 80% of their assets in these sectors can qualify.

² Regulation 15(9) of SI 2006/964 and section 243(8) of FSMA require that an authorised investment fund's name not be undesirable or misleading. COLL 6.9.6 deals with undesirable and misleading names. COLL 6.9.6(2) in particular requires that the name is consistent with the fund's investment objectives or policy.

³ The FSA in Handbook Notice 111 has announced its intention to introduce ESMA's (formerly CESR) guidelines on a common definition for European Money Market Funds into the COLL Sourcebook. This is in accordance with the agreement by all member states to incorporate the guidance into their domestic rules to ensure that all money market funds operate within these rules. One of the conditions within the ESMA/CESR guidelines is that a fund that wants to incorporate the term "Money Market fund" within its name must not take direct or indirect exposure to equities.

Calculation and market value – there is guidance on calculating values for ‘N’ and ‘E’ (as required by paragraph 5 of Schedule 19) in HMRC’s SDRT Customer Newsletter of September 1999 which can be found on the HMRC website, http://www.hmrc.gov.uk/so/sdrt/sdrt_news.htm. This guidance should continue to be followed, with fund managers needing to determine what is exempt (or not) at the date of any valuation used in that calculation. The method of determination of market value should be consistent across all Schedule 19 requirements. Fund managers do not necessarily need to re-evaluate the exempt status of an investment in an underlying scheme at every valuation point. They will need to judge how frequently to re-evaluate each investment depending on the quality of the evidence previously used and the likelihood of any change in the intervening period. Where an investment qualifies for the exemption by only a small margin then frequent re-evaluation would probably be necessary.

Chains of Funds – there could be a situation where a top scheme invests in an underlying scheme that itself invests in other schemes, possibly creating a chain of decreasing transparency. The 20% limit test is determined independently at each level of ownership, and fund managers therefore should not look through the underlying scheme to determine what sort of investments are ultimately held. Rather the units of each underlying scheme in the chain will be exempt or non-exempt depending on what it holds.

The burden of proof, in the event of an HMRC enquiry or audit, would be on the manager of the top scheme to demonstrate that the investment for which they were claiming an exemption met the qualifying conditions in accordance with the evidence available. If they were unable to do this, and remained in doubt as to the nature of the underlying scheme’s investments, then they should classify the investment in the underlying scheme as non-exempt.

Avoidance – if managers were discovered to be using these provisions to attempt to avoid paying tax under Schedule 19 where it were properly payable, there could be penalties and arrears of tax to pay.

Mistakes – where a fund manager classified, in good faith, an interest in an underlying scheme as exempt but that interest later turned out not to qualify, then HMRC would expect the appropriate tax and interest to be paid. Penalties would not be due where this guidance had been followed and the manager could demonstrate reasonable grounds for believing the investment to qualify as exempt.