Title: The Companies Act 2006 (Amendment of Part 23) (Investment Companies) Regulations	**Impact Assessment (IA)**
IA No: BIS0328	**Date:** 01/01/2011
Lead department or agency: BIS	**Stage:** Final
Other departments or agencies: HMRC	**Source of intervention:** Domestic
	Type of measure: Secondary legislation
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Summary: Intervention and Options

RPC Opinion: AMBER

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£-0.05	£-0.05	£0.01m	Yes	In/Out/zero net cost

What is the problem under consideration? Why is government intervention necessary?

Amendments to the Companies Act are necessary to reflect changes to the tax rules for investment trust companies.

HMRC have taken steps to modernise the tax rules for investment trust companies so that unnecessary restrictions on commercial activities are removed, whilst ensuring that unintended tax advantages could not be obtained from investing in investment trusts rather than directly in underlying investments. If these changes by HMRC are to be fully effective, parallel changes to the Companies Act are required.

These changes are fully supported by the Association of Investment Companies.

What are the policy objectives and the intended effects?

HMRC's Impact Assessment dated 26/7/2010 explains the policy objectives of their amendments to tax rules as: Implementation of a new tax framework for Investment Companies that removes unnecessary restrictions on their commercial activities, increased certainty for investors and reduced costs to business; Providing a more flexible framework that prevents unintended tax advantages being gained through investing in an Investment Company; and Making Britain a more attractive domicile for investment trusts. The company law changes facilitate HMRC's regulations but will also simplify the rules, making it easier to meet the conditions that allow investment companies to gain tax advantages.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

1. Do nothing. This means legislation introduced by HMRC, which relies on changes being made to the Companies Act, will not be fully effective, and that not all investment companies able to benefit from the amended tax regime will be able to benefit from relaxed rules on distributions in the Companies Act.

2. Make the necessary amendments to the Companies Act which supports HMRC's parallel legislation modernising the tax regime for investment trust companies. These amendments will bring the company law conditions which apply to distributions by investment companies into line with new conditions for favourable tax treatment. It will also remove company law conditions which are no longer necessary. This will enable investment trust companies to make the distributions necessary to be eligible for favourable corporation tax treatment and enable them to be eligible for both favourable corporation tax treatment and the relaxed distributions regime in the Companies Act.

Will the policy be reviewed? It will/will not be reviewed. **If applicable, set review date:** Month/Year

Does implementation go beyond minimum EU requirements?			No		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** Yes	**< 20** Yes	**Small** Yes	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) that the benefits justify the costs.

Signed by the responsible Minister: Norman Lamb Date: 6 Feb 2012

Summary: Analysis & Evidence

Policy Option 1

Description:

FULL ECONOMIC ASSESSMENT

Price Base Year 2011	PV Base Year 2011	Time Period Years 10	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate:** -0.05

COSTS (£m)	**Total Transition** (Constant Price) Years		**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate	0.1		0	**£0.1**

Description and scale of key monetised costs by 'main affected groups'

Familiarisation with the change in regulations is estimated to cost Investment companies £32,816 based on 320 investment companies with a cost of £102.55. Investment Companies that opt to pay dividends from capital profits will be required to change their Articles of Association, if 10% for each of those Investment Companies with an income remit change their Articles (Table A), then 8 Investment Companies will incurr costs of £2,500 totalling £20,000. This gives transitional costs of £52k.

Other key non-monetised costs by 'main affected groups'

It is clear that there are benefits to business in cash terms but we have been unable to monetise these. The Regulatory Policy Committee have agreed, based on the evidence presented in this impact policy that it is reasonable to treat the measure as a zero OUT for One-in, One-out purposes.

BENEFITS (£m)	**Total Transition** (Constant Price) Years		**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate			£0	**£0**

Description and scale of key monetised benefits by 'main affected groups'

Other key non-monetised benefits by 'main affected groups'

Following discussion with the AIC we believe that shareholders will benefit from an increase in the value of their investments as a result of a relaxation in the regulatory restrictions on distributions by investment companies. There are additional unquantifiable benefits associated with increased demand for income-focused investments which lead to a proportionate increase of work for fund managers (and therefore management fees).

Key assumptions/sensitivities/risks **Discount rate (%)** 3.5

Companies choose to opt into "investment company" status and will only do so if the benefits outweigh the costs.

As not all investment companies will opt to amend their rules on distributions, on advice of the AIC we are estimating a take up of 10% by companies with an income remit and a 1% reduction in discount.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: £0.033	**Benefits:** £0	**Net:** £0.033	Yes	IN/OUT/Zero net cost

Evidence Base (for summary sheets)

Introduction

Investment Companies are professionally managed, pooled, risk-spreading investment vehicles constituted as limited companies incorporated under Company Law. Investment Companies are publicly listed and invest in a diversified portfolio of shares and other securities with the aim of providing a return to their investors.

The company law regime, subject to compliance with conditions, makes it easier for "Investment Companies" as defined by the Companies Act 2006, to pay dividends to their investor-shareholders than it would otherwise be if the ordinary rules regulating dividend payments by public companies were to apply. There is also a separate but parallel tax regime under which, subject to conditions, investment trust companies can obtain favourable corporation tax treatment.

HMRC have taken steps to modernise the tax rules for investment companies so that unnecessary restrictions on commercial activities are removed, whilst ensuring that unintended tax advantages could not be obtained from investing in investment trust companies. Underpinning this tax reform is the desire to attract investment companies to domicile in the UK. If HMRC's changes to the tax rules are to be fully effective, parallel changes to the Companies Act are required.

Investment companies self select whether they want to opt into the relaxed distribution rules under the Companies Act 2006 and whether to opt into favourable corporation tax treatment under the Corporation Tax Act 2010. Companies will only choose these options if they believe the benefits exceed the costs.

The Association of Investment Companies actively lobbied for the majority of these changes, which are deregulatory and they have provided evidence on the likely benefits within this Impact Assessment.

A joint HMRC, Treasury and BIS consultation: 'Modernisation of the Tax Rules for Investment Trust Companies and Modernisation of Company Law Rules on Distributions by Investment Companies' was published on 27 July 2010 (Investment trust companies - consultation document). This set out the high level policy objectives that underpin these amendments and proposed specific amendments to the Companies Act. It was supported by an Impact Assessment written by HMRC (http://www.hmrc.gov.uk/ria/itc-ia-final.pdf).

Background on the Companies Act and Investment Funds

The company law regime is to be found in Part 23 of the Companies Act 2006. This Part of the Companies Act regulates "distributions" (including dividend payments) by companies to their shareholders. Public companies (PLCs) can make distributions out of capital profits and/or revenue profits but they must comply with the net assets restriction in section 831, which prevents a public company from making a distribution if its net assets are lower than, or are reduced below, the aggregate of its called up share capital and undistributable reserves.

These distribution rules for public companies, including the net asset restriction, implement Articles 15 and 16 of the Second EU Company Law European Directive (Directive 77/91/EEC). The essential purpose of the net asset restriction is to protect the company's creditors. When the Directive was being negotiated, it was accepted that during period of falling share prices, investment companies might be unable to pay dividends to their investor-shareholders because of this restriction and that would undermine the purpose of such companies. Therefore the

Directive provides an option for Member States to derogate from the net asset restriction for investment companies as defined by the Directive.

The UK took partial advantage of this option. Therefore under UK law certain investment companies can opt into a relaxed distributions regime which allows them to make distributions out of revenue profits without complying with the net asset restriction. To benefit from this regime, they are required to give notice to the registrar of companies, and they must comply with various conditions which these Regulations will partially amend.

Among the conditions that investment companies must comply with in order to get the benefits of the relaxed distributions regime which allows them to make distributions out of capital profits and the requirement that the company maintains a restriction in its articles of association preventing the paying of dividends out of capital profits. There is also a requirement that the company must not retain more than 15% of its income from securities in respect of each accounting reference period, unless the distributions rules prevent it from doing so. These conditions do not derive from the Directive so are purely domestic, and have been in place since the Companies Act 1980. These additional requirements were put in place essentially to mirror corresponding requirements in the tax legislation. The policy was that only those investment companies eligible for favourable corporation tax treatment should be entitled to the benefit of the relaxed distributions regime.

Rationale for intervention

HMRC published an Impact Assessment to accompany the consultation in July 2010, this sets out the policy objectives of their amendments to tax rules for Investment Companies as:

- Implementation of a new tax framework for Investment Companies that removes unnecessary restrictions on their commercial activities, provides increased certainty for investors, and reduces costs to business;
- Providing a more flexible framework that prevents unintended tax advantages being gained through investing in an Investment Company; and
- Making Britain a more attractive domicile for investment trusts.

If the changes now proposed to the tax rules are to be fully effective, BIS needs to amend the parallel provisions in the Companies Act 2006 dealing with distributions by investment companies. The proposed tax provisions requiring the distributions of most of an investment company's income will not work in all circumstances if the Companies Act provisions remain as they are. Further, investment companies typically rely on both sets of provisions and the amendments to the Companies Act are required to ensure that this can continue to be the case. These amendments are all deregulatory and should increase the number of companies that could opt to receive the benefits gained by registering as an 'investment company'. The amendments are:

- Amend section 832(5)(a) so that the investment company's shares must be admitted to trading on a "regulated market" and not necessarily listed on a recognised UK investment exchange as currently required.
- Widen the requirement in section 833(2)(a) so that the company's business must consist of investing its funds in "shares, land or other assets" rather than "mainly in securities".
- Repeal sections 833(2)(b) and 834 which limit the holdings which an investment company may have in other companies.
- Repeal section 833(2)(d), which prohibits an investment company from retaining more than 15% of its income from securities in respect of each accounting reference period.
- Remove the restrictions on investment companies paying dividends out of capital profits if they want to benefit from the favourable regime for making distributions out of revenue profits. Currently, investment companies that have opted into the relaxed regime for distributions of revenue profits must not pay any dividends out of capital profits and must maintain a prohibition on so doing in their articles.

The proposed changes to the tax legislation will allow more investment companies to benefit from favourable corporation tax treatment. The amendments to the Companies Act set out above will mean that these companies will also be able to take advantage of the relaxed distributions regime in the Act. This will ensure that the two regimes continue to function effectively in parallel. Further, the removal of the Companies Act restrictions on paying dividends out of capital profits will ensure that proposed tax rules about distributing investment income work in all circumstances. Instead of repealing the Companies Act requirement for an investment company not to retain more than 15% of its income from securities in respect of each accounting reference period, BIS could have brought the requirement into line with the amended tax legislation by extending it to cover all investment income. However, there appears to be no good reason to retain such a requirement in the Companies Act. It was originally included in order to mirror the corresponding requirement in the tax legislation but is now considered unnecessary.

The Association of Investment Companies actively lobbied for the majority of these changes and they are deregulatory. While the AIC are confident that the benefits would exceed the costs, they point out that companies opt to register as investment companies under the Companies Act 2006 and will only do so if they consider the benefits exceed the costs. These amendments do not create a compulsory regime for investment companies and it is for companies that can meet the criteria, to self-select to take advantage of the relaxed rules.

Options

1. Do nothing. HMRC's regulations to modernise the tax rules for Investment Companies will not be fully effective. Investment Companies may not be able to take advantage of the liberalised tax rules if they are not also able to take advantage of the relaxed distributions regime under the Companies Act;
2. Make the necessary changes to the Companies Act to reflect the HMRC legislation modernising the tax regime for Investment Companies, enabling investment companies to benefit (as now) from the favourable tax regime and the relaxed distributions regime.

Costs to Business

Option 1 – Do nothing

The primary cost to business of doing nothing will be the loss of benefits envisaged by the amendments to the tax rules that require these accompanying changes to the Companies Act. In addition, business will be confused by the conflicting requirements in the tax rules and the Companies Act.

There are no benefits to business in doing nothing. The usual benefit associated with retaining regulations unchanged is that there is no new legislation for business to understand. However, the associated changes to HMRC's tax rules (due to come into force on 1 January 2012) will lead to a conflict between tax rules and company law and this will cause confusion to business.

Option 2 - Changing the Companies Act to facilitate HMRC's regulations modernising the tax regime for Investment Companies.

In considering the costs and benefits costs to business, it is simpler to separate the costs into 2:

(i) the package of simplifications, consisting of:
- Amending section 832(5)(a) so that the Investment Company's shares must be admitted to trading on a "regulated market" and not necessarily listed on a recognised UK investment exchange.

- Widening the requirement in section 833(2)(a) so that the company's business must consist of investing its funds in "shares, land or other assets" rather than mainly in securities.
- Repealing sections 833(2)(b) and 834 which limit the holdings which an investment company may have in other companies.
- Repealing section 833(2)(d), which prohibits an investment company from retaining more than 15% of its income from securities in respect of each accounting reference period.

(ii) The removal of the restriction preventing investment companies from paying dividends out of capital profits if they wish to benefit from the relaxed rules relating to distributions out of revenue profits.

Costs

(i) The costs associated with implementing the package of simplifications are small and are limited to companies familiarising themselves with the change in law. We estimate familiarisation to be £102.55 per company – this is based on the Annual Survey of Hourly Earnings from the Office of National Statistics that shows that on average, a corporate manager earned £24.22 in 2011; this figure is uplifted by 21% for overheads giving an hourly rate of £29.30. Following consultation with the AIC, we estimated 3.5 hours at £29.30. FAME identifies 320 quoted companies that could be defined as "Investment Companies" under the Companies Act in the UK (currently 200 have opted to become investment companies), therefore we estimate total familiarisation costs of £32,816 (upper band). Currently only 200 of those have registered as "Investment Companies" but all or some of the remaining 120 companies may now choose to 'opt in'.

(ii) The amendment to the Companies Act that allows companies to pay dividends out of capital profits and still benefit from the relaxed regime for distributions out of revenue profits will not require investment companies to pay dividends out of capital profits (unless they need to do this in order to comply with conditions in the tax legislation). Ultimately, it will be a commercial calculation for Investment companies to decide to adopt the change where the benefit is deemed to outweigh the cost.

FAME identifies 320 quoted companies that could be defined as "Investment Companies". Two Hundred of these are companies registered as "investment companies" under the Companies Act 2006 (a sub-set of the 320). It is only those companies that are registered as "investment companies" that are currently prevented from paying dividends out of capital profits, and therefore will have to make changes should they opt to do so.

We approached the Association of Investment Companies (AIC) to assist us in calculating costs and benefits regarding the optional amendment to capital profits. The AIC has explained that this amendment would be attractive to investment companies that provide income funds i.e. pay out income at a particular point rather than accumulate capital. Table A below shows the key income-orientated investment funds (total of 77) and the AIC recommends that these funds should form the basis of the calculation for costs and benefits. They suggest that we should estimate that 10% of these key investment-orientated investment funds will take advantage of this option.

Table A (figures at 31 August 2011)

Sector	**Number of companies**	**Assets £m**	**Average yield (dividends)**	**Average premium (discount)**
UK high income	7	585	6.5%	1.2
UK growth & income	18	5,722	4.5%	1.9
Global growth &	8	2,280	4.4%	2.6

income				
UK growth	16	3,291	2.7%	(9.1)
Global growth	28	15,527	1.9%	(9.4)
Total	**77**	**27,405**		

Source: AIC

The primary costs would be incurred in the requirement to change articles of association to remove the prohibition on distribution of capital profits that currently exist as a result of company and tax law. This is a one-off cost and the Association of Investment Companies have suggested that the cost of amending Articles would be £2,500 per company. Not all Investment Companies will take up this option. We used the AIC suggestion to estimate that 10% of the 77 more popular investment funds will self select to take advantage of this option, therefore calculating additional costs to business of £20,000 (8 x £2,500). These costs are classified as indirect because investment companies have a choice whether to implement this deregulation and they will only do so if they consider the benefits outweigh the costs.

To summarise costs:

- Familiarisation costs of £32,816 (upper band). Part of One In One Out methodology.
- Cost of amending Articles for existing Investment Companies £20,000. As this is indirect, it does not fall into the One In One Out methodology.

Benefits

The AIC provided the following information to assist in completion of this Impact Assessment.

The AIC explained that they consider that the amendment allowing distributions to be made out of capital profits will be attractive to investment companies that provide income funds i.e. rely on dividend payments rather than increase capital value.

According to the AIC the two most popular types of fund for retail investors are 'Global' and 'UK' generalists. All of these funds aim to provide retail investors with a certain level of income. However, some also aim to offer capital growth, as part of a long-term total return mandate, whereas some specialise in higher levels of dividend payments. As a result, these funds are divided into 'Growth', 'Growth & Income' and 'High Income' subsectors.

The current high level of demand for income can be demonstrated by comparing the current average discounts and premiums across these subsectors (see Table A for information sourced from the AIC).

The term 'discount' relates to the amount, in percentage terms, by which the share price of an investment company stands below the current net asset value per share. The term premium refers to the amount by which the share price stands above the current net asset value per share.

Though the explanations for the existence of discounts/premiums are varied, being stock market investments, investment companies are subject to the normal forces of supply and demand. In other words, a company standing at a discount is generally experiencing less demand than one standing at a premium.

As can be seen from Table A (source: AIC), funds which are offering a higher current rate of income are trading in the stock market at a much higher rating than those with lower income levels. In particular, the AIC has highlighted that there is a significant "discount gap" for growth-focused investment company funds compared to the underlying value of the invested assets.

Funds in the Global Growth and UK Growth sectors are often long-established funds with significant capital profits in reserve. These may not wish to change their investment policy significantly in order to deliver high levels of income. Such funds have a 'total return' mandate which might not be best served by allocating too much of the portfolio to income producing assets. The AIC have argued that the relaxation in the distribution rules would allow growth-focused funds to pay out more of their capital value as dividends which would make them more attractive to investors and be reflected in a higher share price for such funds – to the benefit of all investors. AIC calculations based on 10% of such funds adopting this approach and closing the current discount gap by one percentage point suggest possible gains to investment company shareholders of around £20 million a year. However, whilst it is clear that investment companies will benefit from these changes and those for whom the benefits exceed the costs are likely to adopt this approach, the uncertainty over the cause of the current discount gap and the extent to which it might be closed as a result of these changes mean that we have not included it formally within the benefit calculation.

These investment funds will predominately be provided to retail customers. We are unaware of the exact split between retail and business customers therefore the AIC has suggested applying an estimated split of a third of the benefits falling to business investors and the remaining two thirds to retail customers. This reflects that the benefits of narrow discounts would directly benefit the investment company shareholders. This will also assist investment companies to raise capital to expand the funds, increase economies of scale and generate increased investor returns.

While we cannot monetise the benefits of these amendments under the 'One In One Out' methodology, they do represent simplifications to the Companies Act, which are highly valued by the AIC and the Investment Companies they represent.

Benefits to Business

The AIC estimate that approximately one third of the benefits associated with allowing Investment Companies to distribute capital profits would fall to business.

The benefits associated with implementing the package of simplifications set out in (i) are intended to remove the contradictory requirements between the Companies Act and the tax rules that will occur when HMRC's new regulations come into force on 1 January 2012. They are necessary to prevent confusion and to ensure that Investment Companies can take advantage of the modernised tax rules. These benefits are not easily monetised.

HMRC issued an Impact Assessment in June 2010 setting out their changes to the tax rules. HMRC anticipates the changes in the tax rules would bring savings of £1.75 million a year for Investment Companies. We have not incorporated these savings within this IA.

As the FAME data suggests there are 320 quoted investment companies and as there are 200 companies registered as "investment companies" under the Companies Act, there is the potential for an additional 120 companies to register. Therefore it is possible that these 120 companies may decide to become "investment companies" under the Companies Act and therefore benefit from the relaxed distributions rules. These benefits, which are set out below, are not quantifiable.

In addition, those funds that are outlined above (in the section on benefits to investors) which moved from a discount to a premium would be able (as is the case with funds currently at a premium) to issue new shares to meet demand, thereby increasing the size of the fund and improving liquidity. Management fees to fund managers (who are nearly always based in the UK) would therefore rise. A proportion of this increase will be due to attracting new shareholders.

Also, the change would improve the competitiveness of the UK, as this would put the UK into the same position as the main competing offshore jurisdictions for closed-ended funds business, where no such legal restrictions on the use of capital profits to pay dividends exist. The change might therefore see an increase in the launch of UK domiciled funds, with the attendant increase in business activity and tax receipts this implies.

Benefits to Investors

The AIC estimates that approximately two thirds of the benefits associated with allowing investment companies to distribute capital profits in their distributions calculations would fall to retail investors. In addition, investors will have a greater choice of investments should the number of investment companies expand.

Competition assessment

We have considered the potential impact of these amendments on competition. After screening, it has been deemed that no significant adverse impact on competition is anticipated.

Small firms impact test

Having considered the potential impact of these amendments on smaller firms, it has been deemed that smaller firms would not be disproportionately adversely affected. While many investment companies would not be defined as small due to their high turnover, we understand from the AIC that many employ fewer than 10 people. This means they would fall under the micros definition. Therefore, BIS will seek an exemption requesting this amendment should proceed on the basis that these amendments are deregulatory.

Statutory equality duties

We have considered the potential impact of these amendments on race, disability and gender equality and deemed that there will not be a major impact upon minority groups in terms of numbers affected of the seriousness of the likely impact, or both.

Wider impacts

Other specific impact tests have been considered including Health, Environment, Greenhouse Gas Emissions, Human Rights, the Justice System, Rural Proofing and Sustainable Development. Again after initial screening, it has been deemed that the proposed amendments are not expected to have any significant impact.

Risks and assumptions

Companies choose to opt into "investment companies" status and will only do so if the benefits outweigh the costs.

Direct costs and benefits to business calculations (following OIOO methodology)

We have estimated direct benefits to business of £0 and direct costs of £0.033 million. However, it is clear that there are benefits to business in cash terms but we have been unable to monetise these. The Regulatory Policy Committee have agreed, based on the evidence presented in this impact policy that it is reasonable to treat the measures a zero OUT for One-in, One-out purposes.

Summary and preferred option with description of implementation plan

BIS will lay before Parliament in draft the Companies Act (Amendment of Part 23) (Investment Companies) Regulations 2012. This SI supports HMRC's parallel legislation modernising the tax regime for investment companies and enables that legislation to have its full intended effect. These amendments will also ensure that investment companies can (as now) benefit from both the amended tax regime and the relaxed rules about distributions in the Companies Act.

The draft Regulations state a commencement date of 6 April 2012.