EXPLANATORY MEMORANDUM TO THE

THE AUTHORISED INVESTMENT FUNDS (TAX) REGULATIONS 2006

2006 No. 964

1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before Parliament by Command of Her Majesty. This memorandum contains information for the Select Committee on Statutory Instruments.

2. Description

2.1 These draft Regulations restate, consolidate and update the rules for the taxation of Authorised Investment Funds (Authorised Unit Trusts and Open-ended Investment Companies).

2.2 As well as consolidating the detailed rules for the taxation of authorised investment funds in the form of Regulations, they also provide for a different tax treatment to apply to certain investors in a Qualified Investor Scheme (QIS).

2.3 The draft Regulations also provide (from 6 April 2007) for UK residents who are non-taxpayers to be able to receive interest distributions from funds without deduction of tax.

2.4 They also incorporate and update an Extra Statutory Concession (ESC C30) which enabled funds, in some circumstances, to withhold distributions below a 'de minimis' level without tax consequences.

2.5 The regulations also put beyond doubt that authorised investment funds cannot form part of any group arrangements for tax purposes.

3. Matters of special interest to the Select Committee on Statutory Instruments

3.1 None.

4. Legislative Background

4.1 Taxation of Authorised Unit Trusts is currently provided for by section 468 and sections 468H to section 468Q of the Income and Corporation Taxes Act 1988 (ICTA). The taxation provisions relating to Open-ended investment companies are largely contained in Regulations.

4.2 Finance (No. 2) Act 2005 added section 468A ICTA in respect of Open-ended Investment Companies and provided for the repeal of sections 468H to 468Q.

4.3 Finance (No. 2) Act 2005 provides, at section 17(3), the powers for the Treasury to make regulations. These powers are subject to section 19, which provides that a draft of the first set of regulations must first be laid before and approved by resolution of the House of Commons.

4.4 The Financial Services Authority (FSA), acting under the Financial Services and Markets Act 2000, authorises and regulates both types of Authorised Investment Fund.

4.5 The FSA revised the regulatory regime for AIFs in 2004, which permitted a wider range of investment flexibility for authorised funds, and allowed for a new type of fund (a QIS) available only to institutional and sophisticated investors.

5. Extent

5.1 These Regulations apply throughout the United Kingdom.

6. European Convention on Human Rights

6.1 The Economic Secretary to the Treasury, Ivan Lewis, has made the following statement: In my view the provisions of these draft Regulations are compatible with the Convention rights.

7. Policy Background

7.1 The current rules are partly in primary and partly in secondary legislation; and in the Finance (No. 2 Act) the Treasury was given powers to rewrite the details of the regime in regulations. The main taxing and relieving provisions remain in primary legislation. This was done both to enable consolidation of existing rules and to provide the flexibility to make future amendments to enable, or in response to, developments in this fast-moving industry.

7.2 It is intended that consultation with the industry will continue in the future in order to ensure that the regulations reflect further developments.

8. Impact

8.1 A regulatory impact assessment has been prepared and is available on the HMRC website at http://www.hmrc.gov.uk/ria/ria-aif.pdf

9. Contact

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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. At the time, the Government committed to considering whether consequential changes to the tax rules were required.

2. The present rules for AIFs are split between primary legislation and regulations making them difficult to follow. The prime objective of the proposed regulations 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.

3. COLL introduced a new type of AIF called a Qualified Investor Scheme (QIS) for sophisticated and institutional investors. Another objective of these regulations 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.

4. This opportunity is also being taken to make some changes such as allowing UK resident individuals who are non taxpayers to receive interest distributions without tax being deducted at source 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 these 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. 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 more restricted 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 ('substantial QIS holding' 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:

- to 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,
- to bring into legislation, and update, the de minimis rules within what is currently Extra Statutory Concession C30
- the addition of provisions to clarify the status of AIFs in relation to group membership for the purposes of Chargeable Gains and Corporation Tax.

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. Draft regulations and a partial RIA were issued for consultation on 14 December 2005. The final step is laying the regulations to complete the legislative process. A copy of the regulations that were laid on 13 February 2006 is attached to this RIA.

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 are being addressed.

14. **Gross Payments:** The existing arrangements for the payment of distributions that are treated as interest are more restrictive than those dealing with interest paid by banks and building societies in terms of the people who can receive interest payments without deduction of tax at source. Allowing more people to register for gross payment of interest distributions is more efficient overall as it will reduce costs for investors and HMRC by eliminating the need for people to reclaim tax deducted at source. Fund managers may however incur some initial costs to make changes to their systems to cope with an additional category of investor that can receive interest distributions gross. To ensure that funds have adequate time to prepare, this change will apply from 6 April 2007.

15. **Compliance burden when only a small amount is available for distribution:** an extra statutory concession (ESC C30) can be used by AIFs to reduce disproportionate administrative burdens in these circumstances. In line with Government policy, 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. Draft regulations and a partial RIA were published for consultation on 14 December 2005. A summary of the responses received will shortly be published on the HMRC web site. In response to these and continuing discussions with industry bodies, a further category (Qualified Investor Schemes) has been added to the types of investor to whom the QIS 'substantial QIS holdings' rule does not apply. In addition it has been made clear that fund managers and other companies holding units as trading assets and subject to tax on trading profits will not also be taxed under this provision.

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, managed, 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.

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. This will be available on the HMRC website.

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.

31. The saving for non-taxpaying investors and for HMRC may be balanced by corresponding costs to those fund managers who operate 'bond funds'. Managers of such funds with few non-taxpaying investors may consider that the cost outweighs the likely benefits to investors. Comments received have indicated that some system change would be needed to extend gross payments to UK resident non taxpayers. Varying estimates of the time required have been given but all are in agreed that at least six months is required. The Government has decided that, in response to this

and to allow time for these changes, this facility will not take effect until the 2007-8 tax year.

Exchequer Impact

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

Small Firms Impact Test

33. AIF managers normally fall within the large business sector and we do not believe that there will be any significant impact on small firms. Comments were invited on this point and none have been received.

Competition assessment

34. 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

35. 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 once this is in operation. 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.

36. The regulations have been laid before Parliament. Subject to an affirmative resolution of the House of Commons, they will come into effect from 1 April 2006 (for corporation tax measures), 6 April 2006 for income tax measures, and 6 April 2007 for extension of the categories of people that can receive interest distributions gross.

    The general self assessment requirements for investors to maintain records of the cost and sale proceeds of investments in AIFs, and of distributions received from AIFs is unchanged by these regulations. Certain kinds of investors with substantial holdings in a QIS will in addition need to keep track of the size of the fund to determine if or when their holding breaches the 10% limit.

    Individual investors whose income is below the tax paying threshold will be able to request gross payment of interest distributions from ‘‘bond funds’. A new form to make the request will be available on the HMRC

web site. The form will be very similar to the form R85 that currently used to request gross payment of bank and building society interest. It will ask for the same kind of information and require the same kind of declaration concerning liability to UK tax as the R85.

The only additional requirement for funds applies to those that pay interest distributions rather than dividends. Fund managers will need to have systems in place from April 2007 to enable gross payment of interest distributions to non-tax paying individuals. As these funds already make payments gross to non-residents this may not require major change. Managers of bond funds will need to retain the forms received from individuals requesting gross payment, and to make them available for inspection by HMRC in the same way as they already do for declarations received from non-resident investors.

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.

Contact Details

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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.

REGULATORY IMPACT ASSESSMENT

CONSOLIDATION OF AUTHORISED INVESTMENT FUNDS (AIFs) taxation

Statement of Ministerial Approval

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

IVAN LEWIS

ECONOMIC SECRETARY TO THE TREASURY

Date 7 February 2006