EXPLANATORY MEMORANDUM TO

THE INVESTMENT TRUSTS (DIVIDENDS) (OPTIONAL TREATMENT AS INTEREST DISTRIBUTIONS) REGULATIONS 2009

2009 No. 2034

1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before the House of Commons by Command of Her Majesty.

This memorandum contains information for the Select Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 These Regulations introduce an optional tax framework for investment trusts which enables such companies to invest in interest bearing assets without incurring a corporation tax liability that they would otherwise incur.

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

3.1 None.

4. Legislative Context

4.1 These Regulations have been made using the powers contained in section 45 of the Finance Act 2009. This is the first use of those powers.

4.2 An investment trust is a corporate entity which invests pooled funds obtained from investors with a view to making a return for those investors. For tax purposes, a company can be approved by the Commissioners for HM Revenue & Customs as an investment trust. Approval means that while the investment trust is subject to corporation tax on its income in the same way as any other company it is not subject to tax on any gains. It also enjoys exemption from tax on certain capital profits arising from loan relationships and derivative contracts which would otherwise be taxable as income.

4.3 Investment returns are distributed (paid out) by an investment trust to its investors in the form of company dividends and, like any other company dividend, tax at the dividend rate is payable in respect of the dividend. This can have the effect of making investments in assets that produce interest like returns (e.g. corporate bonds which pay interest) less attractive for the investors as the investment trust will be liable to corporation tax on the income received from such assets and additionally the investors suffers tax on the income received, which means that investors usually pay a higher effective rate of tax than if they had invested in the underlying assets directly.

4.4 Section 45 of the Finance Act 2009 enables regulations to be made so that investment trusts that invest in interest bearing assets can treat the distribution of income derived from such assets as payments of interest rather than as dividends, with the consequence that the investor is taxed on the basis of receiving a payment interest, rather than a dividend, from the investment trust. The effect is that the investors are effectively taxed as though they had invested in the underlying assets directly (addressing the problem described in paragraph 4.3 above).

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

- ***What is being done and why***

7.1 The issue of the taxation of investment trusts was the subject of a report published in October 2007 by the Association of Investment Companies entitled “Delivering lower costs and innovation in pooled investments”. The report argued that tax rules acted as a barrier to investment trusts being established in the UK. The report identified the main problem with the tax rules as the absence of a tax-efficient method for UK based investment trusts to invest in bonds. Following that report, industry lobbying and extensive consultations, these Regulations introduce new rules to facilitate investment in interest-bearing assets.

- ***Consolidation***

7.2 This instrument does not amend any other instrument.

8. Consultation outcome

8.1 Drafts of these Regulations have been the subject of formal public consultation and a number of detailed changes have been made as a result.

9. Guidance

9.1 Guidance on the instrument will be published in HMRC’s Corporate Tax Manual.

10. Impact

10.1 An Impact Assessment is attached to this memorandum to cover the introduction of a new tax rules for investment trusts.

11. Regulating small business

11.1 The legislation does not apply to small business.

12. Monitoring & review

12.1 The Government intends to monitor the effects as the industry takes up the options available.

13. Contact

Angela Nagarajah at HM Revenue & Customs Tel: 020 7147 2787 or email: angela.nagarajah@hmrc.gsi.gov.uk can answer any queries regarding the instrument.

Summary: Intervention & Options

Department /Agency:	Title:	
HM Treasury	Impact Assessment of Investment Trust Companies: A new optional tax framework.	
Stage: Implementation	Version: 1.0	Date: 15 July 2009
Related Publications: http://www.hm-treasury.gov.uk/consult_investmenttrust_companies.htm		

Available to view or download at:

http://www.hmrc.gov.uk/ria/index.htm#full

Contact for enquiries: Stuart Gregory   Telephone: 0207 270 6029

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

Currently shareholders in Investment Trust Companies (ITCs) that hold interest-bearing assets can face a different tax treatment than if they had invested into a bond or other interest-bearing asset directly.

What are the policy objectives and the intended effects?

- Providing an elective framework to allow ITCs to invest tax-efficiently in bonds and other interest producing assets;
- Ensuring that UK investors continue to choose their investments for commercial rather than tax reasons;
- Preventing unintended tax advantages being gained through investing in an ITC rather than direct investment; and
- Implementing the framework at no overall increase in cost to the UK Exchequer.

What policy options have been considered? Please justify any preferred option.

1. Do nothing - this would mean that shareholders would continue to face a different tax treatment than if they had invested in the underlying assets directly.

2. Introduce a tax framework to allow tax efficient investment into interest bearing assets - this would mean that shareholders in ITCs would face broadly the same tax treatment as if they had invested in the underlying interest bearing asset directly.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The impact of the measure will be monitored under HMRC's broader plans for monitoring trends in the savings and investment sector. Compliance costs are routinely reviewed 1-3 years.

Ministerial Sign-off

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) the benefits justify the costs.

Signed by the responsible Minister:

.... Date: 20 July 09

Summary: Analysis & Evidence

Policy Option:	Description:
Option 2	Introduce a tax framework to allow tax efficient investment into interest bearing assets

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups'
One-off (Transition)	**Yrs**	The larger part of the cost of the measure is expected to arise from necessary IT system changes carried out by ITCs opting into the new regime. There will be minimal aditional burden to HMRC. Further details of these can be found in the Evidence Base.
£		
Average Annual Cost (excluding one-off)		
£		**Total Cost** (PV) £ Unquantified

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

From the point of view of the Exchequer, the measure is forecast to be broadly revenue neutral

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups'
One-off	**Yrs**	Monetising the benefits arising from the policy is extremely difficult due to the scarcity of data and the limitations of available methods to do so. Accordingly, as explained further in the Evidence Base, they have not been quantified.
£		
Average Annual Benefit (excluding one-off)		
£		**Total Benefit** (PV) £ Unquantifiable

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

The measure is expected to increase competition and widen choice for shareholders and is also designed to maintain the position of the UK as a competitive location for asset management.

Key Assumptions/Sensitivities/Risks While it is not possible to quantify the benefits from the policy precisely; we expect these to outweigh the costs. This is due to the elective nature of the regime, and backed by evidence from industry indicating that the set-up costs are considered small in relative terms.

Price Base Year	Time Period Years	**Net Benefit Range** (NPV) £	**NET BENEFIT** (NPV Best estimate) **£ Positive**

What is the geographic coverage of the policy/option?				UK
On what date will the policy be implemented?				1 Sept 09
Which organisation(s) will enforce the policy?				HMRC
What is the total annual cost of enforcement for these organisations?				£ neg.
Does enforcement comply with Hampton principles?				YES
Will implementation go beyond minimum EU requirements?				No
What is the value of the proposed offsetting measure per year?				£ n/a
What is the value of changes in greenhouse gas emissions?				£ n/a
Will the proposal have a significant impact on competition?				Yes
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices)		(Increase - Decrease)
Increase of £ neg	Decrease of £	**Net Impact** £ neg

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Context to Impact assessment

The Government and industry have been working in close consultation to understand the potential costs arising from, and demand for, this new optional regime. However, these are heavily dependent upon the individual circumstances of ITCs. This, combined with current market conditions, has made aggregate figures very difficult to quantify. As such, this impact assessment focuses on some of the potential costs and benefits that would be faced by individual ITCs rather than the larger, and at present uncertain, effect on the ITC sector as a whole.

Context to framework and consultation

ITCs invest in a diversified portfolio of shares and other securities with the aim of providing a return to their investors. In order to be an ITC, a company must meet certain criteria set out in tax legislation. A company meeting the criteria is not subject to tax on chargeable gains and, among other conditions, must not retain more than 15 per cent of its income from shares and securities.

The issue of the taxation of ITCs was the subject of a report published in October 2007 by the Association of Investment Companies entitled "Delivering lower costs and innovation in pooled investments". The report argued that the UK tax rules acted as a barrier to ITCs being established in the UK. The report identified the absence of a tax-efficient method for UK based ITCs to invest in bonds.

Budget 2008 announced that the Government intended to consider proposals to allow ITCs to invest tax-efficiently in a wider range of assets. In July 2008, the Government published a discussion paper that laid out the new optional tax framework; this was warmly welcomed by industry and was followed, in December 2008, with a summary of responses and further consultation.[1]

Budget 2009 announced the launch date of 1 September 2009.

Costs

Compliance Costs

ITCs will incur costs for opting into and complying with the proposed regime. The main source of these costs is expected to be implementing changes to IT systems. These costs will vary according to the flexibility of existing systems and may also be shared due to single administrators servicing multiple ITCs. Industry has indicated that the above set-up costs are likely to be considered small in relative terms.

ITCs will notify their shareholders of their decision to opt into the new tax regime (and in some cases ITCs may need to seek shareholder approval). Discussions with industry suggest this decision will be amalgamated with other business that requires notifications or shareholder approval, and should therefore not give rise to additional costs. However, the process of

[1]See: http://www.hm-treasury.gov.uk/d/itc_nextsteps.pdf

notifying investors could potentially require ITCs to seek additional tax advice for communications purposes.

Industry has suggested that ITCs opting-in may also incur some ongoing costs from reporting the split of distributions paid to investors by income stream. However, once appropriate IT systems are set-up, the operation of the regime should only give rise to a small additional cost. ITCs will need to apply HMRC for each accounting period. However, as ITCs already apply to HMRC for approval of meeting ITC status, opting into the framework should add minimally to this process.

Change in Administrative Burdens

HMRC has quantified targets to reduce one particular aspect of compliance costs the administration burden on business of disclosing information to HMRC or to third parties. This burden is assessed according to the 'Standard Cost Model' approach, an activity-based costing modelling tool which identifies the activities a business has to do to comply with HMRC's obligations, and which estimates the cost of these activities, including seeking advice and software costs.

As the measure implements a very minor change to the way ITCs apply to HMRC, the change in the overall burden is likely to be minimal, especially once the ITC has become familiar with the new procedure. Similarly, as ITCs put appropriate IT systems in place, any additional complexities of the reporting requirements to investors should be handled at a minimal additional cost, particularly if the ITC makes use of the option to issue electronic vouchers to investors. On this basis, we expect this measure to have a negligible impact on administrative burden targets.

Benefits

Before this Government measure, the Association of Investment Companies' assessment was that ITCs were effectively excluded from investing in bonds due to the existing tax rules. With this new framework, this should no longer be the case.

The new framework moves the point of taxation for interest bearing assets from the ITC to the shareholder, with the result that shareholders face broadly the same tax treatment as they would have had they owned the interest bearing assets directly, allowing ITCs which opt in to compete more effectively in the wider market.

Following ITCs opting in to the new framework the increased competition may contribute to a reduction in charges to investors. This argument was originally put forward by the AIC their 2006 report 'Delivering lower costs and innovation in pooled investments'. Financial Express data held by HMRC confirms that ITCs have, on average, lower annual charges than other comparable investment vehicles,[2] though we can not be certain whether they will offer similarly competitive charges under the new streaming regime, Quantifying benefits arising from any reduction in charges is difficult as these estimates are sensitive to the share of existing business moving into the new framework and the extent to which increased competition will actually succeed in reducing these charges.

By creating a tax-neutral arrangement for ITCs this policy is also designed to improve the attractiveness of the UK as a domicile location.

Overall, the Government expects the measure to deliver benefits to the industry and investors by improving competition and by promoting the UK as a domicile location. However monetising

[2] Financial Express is a fund data company (see; www.financialexpress.net). Data held by HMRC is from June 2009.

these benefits is, extremely difficult due to the scarcity of detailed data. Accordingly, these have not been quantified.

As the new tax regime is optional, we expect that ITC managers (and implicitly investors) will only opt into the new regime if they expect the benefits to outweigh the costs.

Small Firms Impact Test

The ITC industry shows significant variation in the amount of assets held by each company, ranging from a few million pounds to over several hundred million. As mentioned above, set-up and operation costs will vary across firms and may in some cases be shared, as single administrators may cover multiple ITCs. However, the available evidence indicates the absolute costs are unlikely to vary systematically according to the size of the fund. As the regime is elective, the choice of whether to incur these costs will be down to the company itself.

Competition Assessment

Overall, the measure is expected to enhance competition in the market for asset management, thereby contributing to improving its efficiency. Increased competition should improve choice for investors. In particular, one key benefit of the change in regulations stems from the opportunity they provide for ITCs to compete for new business in bond investments. This will allow ITCs to offer investors a wider range of asset classes and portfolio mixes to invest in tax-efficiently. It may also stimulate the industry to develop new types of investments, such as 'lifestyle products'. Overall, the changes are expected to enhance the choice of products available to investors, thereby improving the extent to which these match consumer needs.

Other Impacts

This measure has no impact on Race Equality, Disability Equality, Gender Equality or Human Rights. In addition, this measure has no or negligible impact on Legal Aid, Sustainable Development, Carbon Assessment, Other Environment, Health Impact Assessment or Rural Proofing.

Specific Impact Tests: Checklist

Type of testing undertaken	***Results in Evidence Base?***	***Results annexed?***
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No

Annexes

Control sheet for Impact Assessment

This document should accompany any Impact Assessment to be sent for Ministerial signature. When complete, it should be retained by the Better Regulation and Policy team for audit purposes.

Title of IA	**Version**
Impact Assessment of Investment Trust Companies: A new optional tax framework.	**1.0**

Author
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	Approved by:	Name	Date
1	**Accountable lead official** (HMRC/HMT) assures the Minister that • the impact assessment of this policy is as accurate/ robust as it can be based on the available evidence, and that • all the impacts have been considered, and • the IA is drafted in plain English and • it is proof read and fit for publication	Gwyneth Nurse	13 July 2009
2	**Policy partner** (HMT/HMRC) The policy partner's accountable lead official approves the IA's content and presentation.	Jeremy Tyler	13 July 2009
3	**KAI Senior Analyst** Agrees the following statement may be included in the submission to Ministers: "On behalf of HMRC's chief analyst, KAI have confirmed that the assessment of expected changes to compliance burdens, other resource costs and benefits, and transfers is reasonable in the circumstances, being based on appropriate methodologies and making the best use of available evidence."	Edward Zamboni	13 July 2009
4	**BRPt** Agrees the following statement may be included in the email accompanying the submission to Ministers: "HMRC's Better Regulation and Policy team confirm that this IA complies with best practice and that Better Regulation issues, including consultation, have been considered."	James Holburn	13 July 2009

It is vital that you **proof read your IA carefully** before submission, both for content and for formatting. You need to remove any tracked changes and drafting notes, and to make sure the formatting of the template hasn't been altered. BRPt can help with template issues.