

**EXPLANATORY MEMORANDUM TO
THE AUTHORISED INVESTMENT FUNDS (TAX) (AMENDMENT)
REGULATIONS 2012**

2012 No. 519

1. This explanatory memorandum has been prepared by HM Revenue and Customs on behalf of Her Majesty's Treasury 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 The Regulations amend the Authorised Investment Funds (Tax) Regulations 2006 (S.I. 2006/964) for the following purposes:
 - 2.1.1 The amendments prevent tax benefits arising to a corporate investor in relation to a distribution from an authorised investment fund ("AIF") where no underlying tax has been suffered.
 - 2.1.2 The amendments also ensure that a corporate investor cannot benefit from a tax loss on its holding in an AIF where no economic loss has been suffered.
 - 2.1.3 The amendments make new provision for the tax treatment of dividend distributions made to corporate investors in AIFs, where those distributions are derived in whole or in part from income not chargeable to corporation tax in the AIF.
 - 2.1.4 In a case where an interest distribution is made the corporation tax deduction available to an AIF is restricted to the amount derived from income charged to corporation tax ("CT").
 - 2.1.5 The Regulations also amend the Authorised Investment Funds (Tax) (Amendment No. 3) Regulations 2008 to omit an obsolete transitional provision for certain types of AIF (Qualified Investor Schemes – "QIS") which may have been mis-used in order to allow closely held QIS to be used for transactions designed to avoid tax such as those used in the schemes these regulations intend to block.

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

- 3.1 These Regulations come into force less than 21 days after the date on which they were made. The Department regrets that compliance with

the 21-day rule is not possible in this case. The Regulations block a disclosed avoidance scheme. Unless the Regulations come into force immediately there is a significant risk that participants in such schemes will make distributions before the Regulations come into force so the distributions would escape the effect of the amendments intended to block such schemes.

- 3.2 The amendment made by regulation 6 has effect in relation to distributions made in respect of a distribution period ending at or after the time the Regulations come into force to avoid increasing the administrative burden on an AIF. Distributions which have already been determined in respect of a distribution period (which has ended at the time the Regulations come into force) but which have not yet been paid will not have to be recalculated to take account of the amendment to the calculation rules made by regulation 6.

4. Legislative Context

- 4.1 AIFs are within the charge to corporation tax and are charged at a rate equal to the basic rate of income tax (lower than the standard CT rate). Where a corporate taxpayer holds an interest in an AIF and receives a dividend distribution then any part of that distribution that does not derive from dividends exempt from CT in the AIF is treated by the corporate, not as a dividend distribution, but as an annual payment subject to CT. The distribution is treated as having been made under deduction of tax at the basic rate of income tax.
- 4.2 There are restrictions which limit the right to repayment of the tax deemed to have been deducted.
- 4.3 The amendments made by these Regulations supplement the existing restrictions with a rule which has the effect of removing the deemed tax deduction altogether where the dividend distribution derives from income that has not been charged to CT in the AIF.
- 4.4 Where a corporate holder holds an interest in an AIF which fails the qualifying investments test in section 493 of the Corporation Tax Act 2009 (“CTA 2009”) (this test is failed when the AIF holds at any time more than 60% of its assets in interest bearing investments), then section 490 CTA 2009 requires that the holding is treated as a creditor loan relationship of the corporate holder, but excludes dividend distributions of the AIF from being brought into account in relation to that loan relationship.
- 4.5 The amendments made by these Regulations remove the exclusion in section 490(4) CTA 2009 so that, when section 490 applies all credits and debits in relation to the relevant holding fall to be taken into consideration.
- 4.6 In a case where an AIF makes an interest distribution (which is taxable as interest in the hands of the investor) the AIF can get a deduction for the purposes of its own CT computation. The amendments made by

these Regulations will limit that deduction to the proportion of any interest distribution which derives from income charged to CT in the AIF.

- 4.7 These Regulations also delete an obsolete transitional provision from the Authorised Investment Funds (Amendment No. 3) Regulations 2008 (S.I. 2008/3159). This transitional provision treats a QIS authorised before 1st January 2009 as meeting the genuine diversity of ownership condition in the first accounting period of the scheme. Omitting this provision will prevent schemes which have been authorised before that date but which have not yet started to operate from relying on that deeming provision.

5. Territorial Extent and Application

- 5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

- 6.1 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 In general the policy underlying the taxation of investors in AIFs is that they should be taxed in an equivalent manner to direct investors in the underlying investments.

- 7.2 These Regulations intend to maintain that policy by addressing potential unintended effects as described below.

7.2.1 The first is that amounts received by an AIF and treated as income may be deemed to have been distributed to the participants in the AIF under deduction of tax even though the AIF has suffered no tax in respect of the amounts distributed.

7.2.2 Secondly, corporate investors are in general required to aggregate economic gains and losses on a loan relationship. In a case where a holding in an AIF represents mainly underlying loan relationships then the corporate holder must treat the holding itself as a creditor loan relationship. However dividend distributions of the AIF are currently excluded from that computation which could, in some cases lead to distorted results.

7.2.3 Thirdly an AIF making an interest distribution may be able to gain a deduction in its own tax computation CT greater than the amount of its income that was charged to CT and which was distributed in the interest distribution.

- 7.3 These problems are addressed as described at paragraphs 4.3 to 4.6 above.
- 7.4 The transitional provision in the Authorised Investment Funds (Tax) (Amendment No. 3) Regulations 2008 which treats certain schemes authorised before 1st January 2009 as meeting the genuine diversity of ownership condition in the first accounting period of the scheme is no longer required. Any QIS to which that provision applied should have already have started its first accounting period, if it has not there is no reason why the genuine diversity of ownership condition should be deemed to be satisfied.

- ***Consolidation***

- 7.5 There are no plans to consolidate the revised Regulations in the immediate future.

8. Consultation outcome

- 8.1 There has been no consultation with the industry on these Regulations because of the need to prevent forestalling.

9. Guidance

- 9.1 Draft guidance will be published for comment by HM Revenue and Customs as soon as possible.

10. Impact

A Tax Information and Impact Note covering this instrument will be published on the HMRC website at <http://www.hmrc.gov.uk/thelibrary/tiins.htm>.

11. Regulating small business

- 11.1 The legislation applies to small business.
- 11.2 It is, however, not considered likely to have any impact on small business as typically small business would not be involved in using the schemes that this legislation aims to block

12. Monitoring & review

- 12.1 The Government intends to monitor the legislation for further instances of this type of scheme and will make further regulations if necessary.

13. Contact

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