

QUALIFIED INVESTOR SCHEME: REPLACING THE SUBSTANTIAL HOLDING RULE

Introduction

1.1 A qualified investor scheme (QIS) is an authorised investment fund (AIF) introduced in 2004 and regulated by the Financial Services Authority. Investment in a QIS is open only to ‘eligible investors’ as determined by the regulatory rules. Typically these investors will be either institutional or sophisticated individual investors who can be expected to understand the risks involved in a wide range of investments.

1.2 As the QIS regulatory regime permits more flexible investment strategies than UCITS¹ or NURS² and limits its investor base, the Government introduced an anti-avoidance rule under powers in Finance Act 2005 which was designed to prevent investors from gaining tax advantages by using a QIS which did not represent a genuine pooling of investors’ funds. The tax advantages include the deferral or mitigation of tax on chargeable gains.

1.3 This anti-avoidance rule (known as the substantial holding rule) imposes a tax charge on certain investors if their units (either alone or together with associates or connected persons) represent rights to 10 per cent or more of the net asset value of the QIS. The Government recognises that the mechanical nature of the anti-avoidance rule in practice has acted as a barrier to the development of QISs. The Government therefore announced in Budget 2008 that it was minded to replace this rule with a more flexible test.

1.4 The Government’s aim in replacing the substantial holding rule is to:

- remove tax as a barrier to QISs;
- reduce compliance obligations for investors in QISs; and
- make the UK a more competitive location in which to launch authorised investment funds for sophisticated and institutional investors.

1.5 This paper sets out a more purposive rule which aims to retain the Government’s policy intention whilst delivering the aims set out above.

Genuine Diversity of Ownership

1.6 The Government proposes that the existing substantial holding test should be replaced with a ‘genuine diversity of ownership’ rule. The aim of this is to ensure that the tax advantages are only available where the QIS is ‘widely held’. This approach was first used in the regulations for Property Authorised Investment Funds³ which followed extensive consultation with industry.

¹ Undertakings for Collective Investment in Transferable Securities

² Non-UCITS Retail Scheme

³ Regulation 69J of the Authorised Investment Funds (Tax) Regulations 2006 (Statutory Instrument 2006 No. 964 as amended by Statutory Instrument 2008 No. 705)

1.7 The introduction of a genuine diversity of ownership test will mean that a QIS will have to comply with certain conditions. These will require a QIS to ensure that its:

- documentation includes binding statements covering its intended categories of eligible investors;
- shares are made available to eligible investors; and
- manager continues to act in accordance with the prospectus to attract eligible investors in its stated target market.

1.8 The conditions are set out in detail in the attached draft regulations.

1.9 In addition, the Government proposes that if an investor in the QIS is a feeder fund, then the conditions of the genuine diversity of ownership test may be met after taking into account the investors in that feeder fund. This mirrors the conditions in the regulations for Property Authorised Investment Funds.

1.10 The current substantial holding rules do not apply for certain categories of ‘participants’. These include certain life insurance companies and pension funds. To align this with the genuine diversity of ownership condition for Property Authorised Investment Funds, the Government intends that the genuine diversity of ownership will apply to all QISs, irrespective of the type of investor.

1.11 In order to help provide certainty for a QIS, the Government intends to provide an optional advance clearance procedure. A QIS will be able to use this to gain assurance that its documentation complies with the genuine diversity of ownership rules.

Breaching conditions

1.12 The Government intends to introduce rules to provide for the situation where a QIS breaches the genuine diversity of ownership condition.

1.13 Given the way the genuine diversity of ownership rule works, it is difficult to see how a QIS would inadvertently breach the rules. However, the Government welcomes views on whether there is a need for inadvertent breach conditions to be introduced and if so, how and under what circumstances those rules might apply.

1.14 If a QIS is deliberately or negligently operated in a manner which ensures that it does not satisfy the genuine diversity of ownership condition, then a sanction is required. In this circumstance, the Government proposes that the QIS would not qualify to be taxed as a collective investment scheme.

Next Steps

1.15 The Government welcomes comments from interested parties, in particular existing and prospective QIS providers, on the proposals set out in this paper and the draft regulations.

1.16 No Impact Assessment has been produced for this proposal as the expected impact on the private or voluntary sectors is anticipated to be negligible.

1.17 Interested parties should send their comments on this paper by Wednesday 22 October 2008 to:

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 Assets, Savings and Wealth
 HM Treasury
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 London
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 Tel: +44 (0) 20 7270 6031
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1.18 The date the Government intends to replace the substantial holding rule will be subject to responses to this paper and accompanying draft regulations.

Confidentiality Disclosure

1.19 Information provided in response to this paper, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004).

1.20 If you ask us to treat the information that you provide as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department. The Department will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

About the consultation process

This paper has been conducted in accordance with the consultation criteria in the Cabinet Office Code of Practice. If you wish to access the full version of the Code, you can obtain it at:

<http://www.cabinetoffice.gov.uk/regulation/consultation/code/index.asp>

The consultation criteria

- Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
- Be clear about who may be affected, what questions are being asked, and the timescale for responses.
- Ensure that your consultation is clear, concise and widely accessible.
- Give feedback regarding the responses received and how the consultation process influenced the policy.

- Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
- Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

If you feel that the consultation does not satisfy these criteria, or if you have any complaints about the process, please contact:

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Freedom of Information contact

Any Freedom of Information Act queries should be directed to:

Correspondence and Enquiry Unit
Freedom and Information Section
HM Treasury
1 Horse Guards Road
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DRAFT REGULATIONS

- 1.1** These draft regulations work by replacing the existing regulations covering the substantial holding rule and inserting new regulations into The Authorised Investment Funds (Tax) Regulations 2006¹. Existing regulations for authorised investment funds include definitions therefore there is no need to redefine terms that have already been defined.
- 1.2** The draft regulations include provisions for a transition period applying to existing QISs.
- 1.3** The Government invites comments on the draft regulations.

¹ Statutory Instrument 2006 No.964 as amended by Statutory Instruments 2006 No.3239, 2007 No. 683 and 2008 No. 705

STATUTORY INSTRUMENTS

2008 No.

INCOME TAX

CORPORATION TAX

CAPITAL GAINS TAX

The Authorised Investment Funds (Tax) (Amendment No. []) Regulations
2008

Made - - - - - ***

Laid before the House of Commons ***

Coming into force - - - - - ***

The Treasury make the following Regulations in exercise of the powers conferred by sections 17(3) and 18 of the Finance (No. 2) Act 2005⁽²⁾.

Citation, commencement and effect

1.—(1) These Regulations may be cited as the Authorised Investment Funds (Tax) (Amendment No. []) Regulations 2008 and shall come into force on [date].

(2) These Regulations have effect in relation to qualified investor schemes authorised by the Financial Services Authority on or after the date these Regulations come into force.

(3) These Regulations also have effect, in accordance with paragraph (4) below, in relation to qualified investor schemes authorised by the Financial Services Authority before the date these Regulations come into force.

(4) These Regulations—

(a) shall not have effect—

(i) in relation to an accounting period of a qualified investor scheme which commenced before the date these regulations come into force and which ends on or after that date, or

(ii) in relation to the accounting period next following the accounting period referred to in paragraph (i) above; but

(b) shall have effect in relation to all accounting periods following the accounting period referred to in sub-paragraph (a)(ii) above.

⁽²⁾ 2005 c. 22.

Interpretation

2. In these Regulations—
“qualified investor scheme” has the meaning it has in regulation 9 (in the inserted regulation 14A(5)).

Amendment of the Authorised Investment Funds (Tax) Regulations 2006 (S.I. 2006/964)

3. The Authorised Investment Funds (Tax) Regulations 2006⁽³⁾ are amended as follows.

Amendment of regulation 10

4. After paragraph (3) of regulation 10 (general rule for loan relationships: exclusion of capital profits, gains or losses) insert—

“(4) This regulation is subject to regulation 14A (tax treatment of qualified investor schemes).”.

Amendment of regulation 11

5. After paragraph (3) of regulation 11 (general rule for derivative contracts: exclusion of capital profits, gains or losses) insert—

“(4) This regulation is subject to regulation 14A (tax treatment of qualified investor schemes).”.

Amendment of regulation 12

6. After paragraph (3) of regulation 12 (accounts prepared in accordance with UK generally accepted accounting practice) insert—

“(4) This regulation is subject to regulation 14A (tax treatment of qualified investor schemes).”.

Amendment of regulation 13

7. In paragraph (3) of regulation 13 (treatment of interest distributions for purposes of loan relationships) after “regulation 14” insert “and regulation 14A (tax treatment of qualified investor schemes)”.

Amendment of regulation 14

8. In regulation 14 (treatment of deficits on loan relationship) at the end insert “This is subject to regulation 14A (tax treatment of qualified investor schemes).”.

Insertion of Part 2A

9. After regulation 14 (treatment of deficits on loan relationships) insert the following Part—

“PART 2A

Qualified Investor Schemes: genuine diversity of ownership condition

Tax treatment of qualified investor schemes

14A.—(1) The provisions in paragraph (2) below shall not apply to a qualified investor scheme in relation to an accounting period of the scheme unless the genuine diversity of ownership condition (see regulation 14B) is met in relation to that accounting period.

(2) The provisions referred to in paragraph (1) above are—

- (a) the provisions of Part 2 of these Regulations,
- (b) the provisions of Part 4A of these Regulations,

⁽³⁾ S.I. 2006/964; relevant amending instruments are S.I. 2006/3239, 2007/683 and 2008/705.

- (c) where the qualified investor scheme is an authorised unit trust scheme, section 468(1A) of ICTA,
- (d) where the qualified investor scheme is an open-ended investment company, section 468A(1) of ICTA,
- (e) in subsection (1) of section 99 of TCGA 1992 (including as modified by these Regulations) the words “except that nothing in this section” to the end of that subsection, and
- (f) section 100 of TCGA.

(3) Where the genuine diversity of ownership condition is not met in relation to an accounting period of the scheme paragraph (4) below shall also apply.

(4) Where this paragraph applies—

- (a) section 13A of ICTA (if it would not otherwise apply) shall apply to the qualified investor scheme whether or not the scheme is a close company; and
- (b) the total amount shown in the distribution accounts available for distribution to participants must only be shown as available for distribution in accordance with paragraph (1)(b) of regulation 17 (contents of distribution accounts).

(5) In these Regulations a “qualified investor scheme” means a fund, authorised by the Financial Services Authority, in which a statement that the fund is a qualified investor scheme is included in the instrument constituting the scheme.

(6) For the purposes of these Regulations, in relation to a qualified investor scheme, the “instrument constituting the scheme” means—

- (a) in relation to an open-ended investment company, the instrument of incorporation, and
- (b) in relation to an authorised unit trust scheme, the trust deed.

The genuine diversity of ownership condition

14B.—(1) The genuine diversity of ownership condition is that the qualified investor scheme must meet Conditions A to F throughout the accounting period.

(2) Condition A is that the scheme documents—

- (a) contain a statement that units in the scheme will be widely available, and
- (b) specify the intended categories of investor.

(3) Condition B is that the specification of the intended categories of investor referred to in paragraph (2)(b) above does not have the effect of limiting investors to a limited number of specific persons or specific groups of connected persons.

(4) Condition C is that units in the scheme—

- (a) must be marketed and made available sufficiently widely to reach the intended categories of investors, and
- (b) must be marketed and made available in a manner appropriate to attract those categories of investors.

(5) Condition D is that the scheme documents specify that the manager of the scheme must market and make available the units in the scheme in accordance with Condition C.

(6) Condition E is that a person qualified to invest in the scheme may, without difficulty, obtain information about the scheme and acquire units in it.

(7) Condition F is that the charges and minimum investment in relation to the scheme are not imposed on investors at such levels as would—

- (a) deter a reasonable investor within the intended categories of investor from investing in the scheme, or
- (b) render it unlikely that some categories of the intended categories of investor would choose to invest in the scheme.

(8) The qualified investor scheme meets the genuine diversity of ownership condition if—

- (a) an investor in the scheme is a unit trust scheme (a “feeder fund”), and

- (b) paragraphs (2) to (7) above are met in relation to the scheme after taking into account the intended investors in the feeder fund.
- (9) If paragraph (8) applies the qualified investor scheme and the feeder fund must have the same manager (or proposed manager).
- (10) For the purposes of this regulation—
 - (a) sections 993 and 994 of ITA 2007 (connected persons) apply in the case of a person chargeable to income tax, and
 - (b) section 839 of ICTA (connected persons) applies in the case of a person chargeable to corporation tax.
- (11) In this regulation “scheme documents” means—
 - (a) the instrument constituting the scheme, and
 - (c) the scheme’s prospectus in issue for the time being (including any supplements to a prospectus).

Clearance in relation to the genuine diversity of ownership condition

14C.—(1) An application for clearance that a qualified investor scheme meets the genuine diversity of ownership condition may be made in writing to HM Revenue and Customs by the manager (or proposed manager) of a qualified investor scheme.

(2) An application for clearance must be accompanied by the instrument constituting the scheme and its prospectus in the form in which it is proposed that those documents will apply at the beginning of the first accounting period of the scheme for which clearance is sought.

(3) The officer of Revenue and Customs dealing with the application for clearance may require the manager (or proposed manager) to provide further particulars if the officer thinks that full particulars of the scheme have not been provided.

(4) HM Revenue and Customs must notify the applicant within 28 days of the receipt of the particulars (or, if paragraph (3) applies, of all further particulars required) that they—

- (a) give clearance that the scheme meets the genuine diversity of ownership condition;
- (b) give that clearance subject to conditions; or
- (c) refuse to give that clearance.

(5) The qualified investor scheme (and investors in that scheme) may not rely on a clearance given under this regulation if—

- (a) at the beginning of the first accounting period of the scheme to which the clearance relates (and at the beginning of each subsequent accounting period), a relevant statement in the instrument constituting the scheme or in its prospectus in issue for the time being is not in accordance with a relevant statement in the documents considered by HM Revenue and Customs before giving clearance;
- (b) the scheme acts or is operated in contravention of a relevant statement in the instrument constituting the scheme or in its prospectus in issue for the time being; or
- (c) the instrument constituting the scheme or the scheme’s prospectus in issue for the time being is amended.

(6) But paragraph (5)(c) above does not apply if the manager of the scheme has obtained a clearance given under this regulation which applies to the amendment.

Inadvertent breach of genuine diversity of ownership condition

14D.—*[Marker: possible regulation]*

Amendment to regulation 48

10. After paragraph (3) in regulation 48 (dividend distributions: general) insert—

“(4) This regulation does not apply in respect of a holding in a qualified investor scheme if the scheme has not met the genuine diversity of ownership condition (see regulation 14B) in relation to the distribution period.”.

Insertion of regulation 51A

11. After regulation 51 (cases where participant is the manager of the fund) insert—

“Participants chargeable to corporation tax: holdings in qualified investor schemes where scheme does not meet the genuine diversity of ownership condition

51A.—(1) This regulation applies in a case where a participant has a holding in a qualified investor scheme and the scheme has not met the genuine diversity of ownership condition (see Regulation 14B) in relation to an accounting period.

(2) If this regulation applies—

- (a) section 212 of TCGA (annual deemed disposal of holdings of unit trusts etc.) shall not apply to the participant in relation to that accounting period, and
- (b) paragraph 4 of Schedule 10 to FA 1996 (company holdings in unit trusts and offshore funds) shall not apply to the participant in relation to that accounting period.”.

Omission of regulations 53 to 69

12. Omit Chapter 4 of Part 4.

Insertion of regulation 69DA

13. After regulation 69D (conditions for this Part to apply to company) insert—

“Conditions for this Part to apply to a company where the company is also a qualified investor scheme

69DA. Where an open-ended investment company is also a qualified investor scheme (see regulation 14A) and for an accounting period the company meets the genuine diversity of ownership condition in regulation 14B the company shall be treated as also meeting the genuine diversity of ownership condition in regulation 69J for the accounting period if it would not otherwise do so.”.

Amendments to Part 2 of the Schedule

14. In Part 2 of the Schedule (index of expressions defined or otherwise explained in these regulations)—

- (a) omit the entries in the index for the following expressions—
 - (i) “Chargeable measuring date (in Chapter 4 of Part 4)”,
 - (ii) “Difference in value (in Chapter 4 of Part 4)”,
 - (iii) “Disposal (in Chapter 4 of Part 4)”,
 - (iv) “Earlier measuring value (in Chapter 4 of Part 4)”,
 - (v) “First measuring value (in Chapter 4 of Part 4)”,
 - (vi) “Later measuring value (in Chapter 4 of Part 4)”,
 - (vii) “Market value (in Chapter 4 of Part 4)”,
 - (viii) “Measuring date (in Chapter 4 of Part 4)”, and
 - (ix) “Substantial QIS holding (in Chapter 4 of Part 4); and
- (b) in the expression “qualified investor scheme” for “53(3)” substitute “14A(5)”.

Name

Date

Name
Two of the Lords Commissioners of Her Majesty's Treasury

EXPLANATORY NOTE

(This note is not part of the Regulations)