

Tax elected funds: a discussion paper

July 2008



HM TREASURY



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a discussion paper

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SUMMARY

1.1 Budget 2008 announced a package of proposals to enhance the competitiveness of the UK as a place for funds to locate. One of the key proposals was for the Government to engage with industry to consider a direct tax exemption for Authorised Investment Funds based in the UK. This discussion paper sets out the Government's thinking on how to deliver a more competitive tax regime for Authorised Investment Funds and seeks industry views on a proposed tax framework.

2

INTRODUCTION

2.1 The Government is committed to ensuring that the UK retains its position as a leading international financial centre. The ongoing strength of the UK's asset management sector is a key priority for the Government. UK-based firms manage £3.8 trillion of assets and contribute around 0.69 per cent of GDP¹, employing over 25,000 people. An efficient asset management sector also plays a vital role in the performance of the whole economy by helping to unite those with capital to invest with profitable investment opportunities.

2.2 The Government is also committed to ensuring that the UK retains its strength as a location for all aspects of the asset management business. Working closely with sector representatives, in particular following the publication of the report commissioned by the Investment Management Association on Taxation and the Competitiveness of UK Funds² the Government has already acted to:

- introduce a new regime for the taxation of Property Authorised Investment Funds (Property AIF);
- consult on a modernised and simplified tax regime for investment into offshore funds;
- allow electronic transfer of ownership of shares and units in investment funds;
- consult on options to reform stamp duty reserve tax Schedule 19;
- introduce new tax rules to facilitate the development of the proposed regulatory regime for Funds of Alternative Investment Funds; and
- improve trust and understanding between the asset management sector and the Government, particularly on tax issues.

2.3 The marketplace for funds has changed significantly in recent years with the introduction of cross border sales of authorised unit trusts and open-ended investment companies, in particular, the pan-European retail UCITS³.

2.4 To respond to these challenges, the Government intends to deliver further improvements to the UK framework for asset management. Budget 2008 announced a package of measures on asset management taxation⁴ that the Government will take forward over the next year. One of these announcements was that the Government would engage with industry to consider a direct tax exemption for Authorised Investment Funds (AIFs), broadly taxing the investor as if they held the underlying assets directly.

2.5 The tax framework in this document sets out the Government's thoughts on how to create a special, elective regime for UK funds. The framework is based around moving the point of taxation from the AIF to the investor, with the result that investors face broadly the same tax treatment as they would have had they owned the underlying

¹ *Fund Management 2007*, IFSL Research, October 2007

² *Taxation and the Competitiveness of UK Funds*, KPMG, October 2006

³ *Undertakings for Collective Investment in Transferable Securities*

⁴ *Budget 2008 Stability and opportunity: building a strong, sustainable future*, HM Treasury, March 2008

assets directly. As in other leading fund locations, the fund will remain a taxable entity. However, in order to enable funds to market themselves more competitively, alongside the existing exemption from capital gains tax, defined streams of income will not be taxable within an AIF which elects to be within the new tax regime. The Government is therefore describing this tax regime as a Tax Elected Fund (TEF).

2.6 The Government's main objective putting forward these proposals is to ensure that the UK remains a competitive place for funds to locate. In addition, the Government will:

- balance any proposals against the need to ensure sound and sustainable public finances;
- seek to ensure that UK investors continue to choose their investments for commercial rather than tax reasons; and
- seek to prevent unintended tax advantages being gained through investing in an AIF rather than direct investment.

3

TAX FRAMEWORK

3.1 The key structural features of the proposed framework for Tax Elected Funds (TEFs) are outlined below.

Authorised Investment Funds (AIFs)

3.2 The Government envisages that a new tax-regime for TEFs would be available to all AIFs. This means that both UK tax resident authorised unit trusts and open-ended investment companies, whether UCITS, NURS¹ or QIS², would be able to apply for TEF status.

Elective regime

3.3 AIFs would be able to elect into the TEF regime subject to meeting specific conditions. AIFs who do not wish to be within a new tax regime or are unable to meet the conditions will retain their existing UK corporation tax treatment. The Government envisages that an election into the new regime will be irrevocable to provide certainty for funds, investors and the Government.

Double taxation treaties

3.4 AIFs currently enjoy access to the UK's extensive network of double taxation treaties. Treaty benefits vary but will generally include access to reduced rates of withholding tax on dividends and interest received from abroad. Funds may also benefit from exemption from foreign capital gains taxes and access to the treaty's mutual agreement procedure through which disputes with the overseas taxation authority may be resolved.

3.5 The Government understands that the ability to access double taxation treaties is important for many AIFs, depending on their investment portfolio. Whether an AIF which has elected to become a TEF will continue to enjoy access to a particular double taxation treaty may depend on the treaty partner's attitude to such funds and their new tax status. The Government is therefore unable to provide certainty to AIFs on the effect of electing to be a TEF on their access to double tax treaties, although this will not disadvantage TEFs in comparison to similar funds in other jurisdictions. The double taxation treaty position of funds that do not elect into the new regime should be unaffected.

Genuine diversity of ownership

3.6 The Government first introduced a genuine diversity of ownership condition as part of the tax regime for Property AIFs³. The genuine diversity of ownership condition ensures that the fund is made available to a wide range of investors. To prevent TEFs being used to obtain unintended tax advantages, to elect to become a TEF, a fund will have to comply with the genuine diversity of ownership conditions. The Government

¹ Non-UCITS Retail Scheme

² Qualified Investor 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)

envisages that these conditions will be similar to those set out in the regulations for Property AIFs on which guidance⁴ is available from HMRC.

Tax treatment of income, gains and distributions

3.7 One of the main benefits of the current tax regime for UK AIFs is that gains on disposal of investment assets are not generally subject to UK tax⁵. Alongside this exemption from chargeable gains, the Government proposes that UK AIFs which elect to become a TEF will not pay tax on certain investment income.

3.8 As stated in paragraph 2.5 above, in designing the framework for TEFs, the Government is aiming to move the point of taxation from the AIF to the investor, with the result that investors into a TEF will face broadly the same tax treatment as they would have had they owned the underlying assets directly. In order to achieve this, the Government proposes that a fund electing to be a TEF will have to ensure that income remains identifiable as it passes through the fund to its investors. This is required as certain types of income are taxed differently in the hands of either institutional or individual investors. This has already been achieved in the tax rules for Property AIFs, where three streams of income are identified for funds electing into the Property AIF regime. Although the Government recognises that these rules will result in additional administration for a fund electing to be a TEF, the rules are required in order to deliver a competitive tax regime balanced against the need to ensure sound public finances.

3.9 When UK investors receive distributions from a TEF their tax treatment will depend on the nature of the assets from which the income has been generated and, of course, on their tax position.

3.10 The paragraphs below set out the different types of income that UK AIFs currently receive and the proposed tax treatment of this income in a fund which elects to be a TEF.

UK dividend income

3.11 In line with the current treatment, investment income which is currently non-taxable for UK corporates (i.e. UK dividend income) will be distributed to investors as a UK dividend. For tax purposes, UK investors will be treated as receiving UK dividend income, including the non-payable dividend tax credit.

Foreign investment income

3.12 Income from foreign dividends will not be taxable in a TEF.

3.13 Because foreign dividend income will not be taxable, TEFs will not be subject to double taxation and therefore will not be able to claim any expense or credit relief for overseas tax paid. A TEF will not be treated as transparent for UK tax purposes therefore no credit will be available for the investor for any overseas tax paid.

3.14 Where a fund invests overseas and this investment is treated as a creditor loan relationship, this investment income will be treated in the same way as interest income (see paragraph 3.21).

⁴ www.hmrc.gov.uk: Company Taxation Manual CTM 48816

⁵ Gains on disposals of investments in non-distributing offshore funds are subject to tax as income.

3.15 There are also two current issues which impact upon the UK tax treatment of foreign dividends. HM Treasury is currently reviewing the treatment of UK corporate entities receiving foreign dividend income. This is part of the consultation on Foreign Profits⁶.

3.16 HM Treasury is also currently working to reform the tax rules for UK individuals who receive dividends from overseas companies. This reform is scheduled to be completed in Finance Bill 2009.

3.17 The outcome of these reforms will impact upon the way that foreign dividend income is treated in an AIF which remains within the existing corporation tax rules and for the treatment of distributions to investors in an AIF which elects to be a TEF.

Property investment income

3.18 In April 2008 a new tax regime was introduced for open-ended investment companies investing in property. This tax regime provides a level-playing field for the open-ended equivalent of a UK-REIT. Like UK-REITs, the tax regime for Property AIFs includes conditions to ensure that the Government retains its right to tax income from UK land and property.

3.19 If the Government were to permit TEFs to invest in property, then the ten per cent corporate ownership test would need to be imported from Property AIFs. Given that there is already a vehicle which allows investors to invest tax efficiently in property via open-ended funds and the complexity that allowing property investment involves, the Government is minded to stipulate that funds electing to be a TEF will not be permitted to invest in property.

3.20 The Government will consider whether it would be appropriate to allow a TEF to have a small proportion of investment in property to enable mixed fund investment strategies.

Other income

3.21 A TEF will also not be taxed on interest and other investment income (i.e. investment income not included in paragraphs 3.11 – 3.20 above). The Government envisages that the other investment income will be distributed to investors as if it was an interest distribution and subject to tax in the hands of the investor accordingly.

Offshore income gains

3.22 Under current offshore fund taxation rules⁷, where a UK AIF invests into a non-qualifying offshore fund it only pays tax during the holding of that investment if it receives income. Instead, the UK AIF (like other investors into non-qualifying offshore funds) pays tax as if the gain it makes on disposal of its interest in the fund is an income return, rather than a return on capital. This gain is termed an offshore income gain. The tax treatment aims to compensate, to an extent, the UK Exchequer for the fact that the UK investor is able to defer tax on income arising in the offshore fund until eventual disposal. The regulatory rules means that offshore income gains are not available for distribution to the AIF's investors.

⁶ Taxation of the foreign profits of companies: a discussion document, HM Treasury, June 2007

⁷ Chapter V Income and Corporation Taxes Act 1988.

3.23 The Government recognises that the tax treatment of offshore income gains within a TEF will require careful consideration, balancing fairness for investors with simplicity. The Government invites comments on how an offshore income gain could be treated in a TEF whilst maintaining the Government's policy intention. In addition, within the document entitled *Offshore funds: next steps*⁸, the Government announced that it will consider if and how an annual notional income yield based upon the underlying investment would work. The Government welcomes views from industry as to if and how an annual notional income yield would work in a TEF.

Expenses

3.24 The Government is considering whether any special rules will be required for allocating expenses within a TEF.

Existing tax regimes

3.25 The Government also needs to consider the impact of a new regime on the existing tax regimes for UK authorised investment funds. The Government intends to retain the Property AIF regime and welcomes industry's views on whether the 'bond fund' regime should also be retained. In addition, the Government will also consider the impact of the proposals set out in this paper on the proposed elective tax regime for Funds of Alternative Investment Funds⁹.

Breaching conditions

3.26 As in the Property AIF tax regime, the Government intends to introduce breaching conditions for non-compliance as part of the conditions of electing into the TEF regime. The Government intends that where a breach of the TEF rules is minor and inadvertent and remedied without undue delay, no adverse UK tax consequences will arise.

3.27 In the case of repeated non-compliance or deliberate breaches the Government envisages that a TEF would lose its status. In this situation, the fund will not be permitted to re-elect to be a TEF at a later date.

Transitional provisions

3.28 The Government intends to include transitional provisions for AIFs wishing to elect to be a TEF. Further detail on transitional provisions will be provided as the TEF regime is developed.

⁸ *Offshore funds: next steps*, HM Treasury, March 2008

⁹ *Funds of alternative investment funds: a tax framework*, HM Treasury, February 2008

4

IMPACT ASSESSMENT

4.1 The Impact Assessment (IA) is published within this document and should be read in conjunction with it. The IA considers qualitative, and where possible, quantitative costs and benefits for the proposals to introduce a new elective tax regime in the UK for authorised investment funds. This is a consultation stage IA, which is reflected in the fact that there are, as yet, no quantitative estimates.

4.2 The Government will continue to undertake further analysis during the consultation period with the intention of publishing a subsequent version of the IA. The Government welcomes comments from interested parties to aid with the analysis used in this impact assessment.

Summary: Intervention & Options

Department /Agency: HM Treasury	Title: Impact Assessment of Tax Elected Funds	
Stage: Consultation Stage	Version: 1	Date: July 2008
Related Publications: "Tax elected funds: a discussion paper" (published July 2008)		

Available to view or download at:

<http://www.hm-treasury.gov.uk>

Contact for enquiries: Sue Harper

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

The marketplace for funds has changed significantly in recent years with the introduction of cross border sales of authorised unit trusts and open-ended investment companies, particularly the pan-European retail UCITS. Budget 2008 announced that the Government would engage with industry to consider a direct tax exemption for Authorised Investment Funds (AIFs) which would broadly tax the investor as if they held the underlying assets directly.

What are the policy objectives and the intended effects?

The Government's main objective in these proposals is to ensure the UK remains a competitive place for funds to locate. This will be achieved by moving the point of taxation from the AIF to the investor, resulting in investors facing the same tax treatment as they would have had they owned the underlying asset directly. The fund will remain a taxable entity but to enable funds to market themselves as not subject to tax on certain income and gains, defined streams of income will not be taxed within the AIF.

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

1. Do nothing – this would mean that AIFs and their investors would continue with their existing tax treatment.
2. Modernise the tax regime for authorised investment funds by offering AIFs an elective tax regime that broadly taxes the investors as if they held the underlying assets directly.

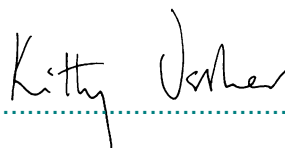
When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The Government intends to monitor the effects of the policy on an ongoing basis.

Ministerial Sign-off For Consultation Stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible Minister:



.....Date: July-08

Summary: Analysis & Evidence

Policy Option: Preferred Option 2	Description: Proposals to introduce an elective tax regime for authorised investment funds
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COSTS	ANNUAL COSTS	Description and scale of key monetised costs by 'main affected groups' AIFs electing into the new regime will incur one-off costs which include operational costs from adapting IT systems, cost incurred to familiarise with the new rules and the costs of information and disclosure to unit holders and shareholders. AIFs electing in will also incur a small on-going cost from operating within the new proposed regime.		
	One-off (Transition) Yrs			
	£ tbc			
	Average Annual Cost (excluding one-off)			
	£ small	Total Cost (PV)	£ tbc	
Other key non-monetised costs by 'main affected groups' None				

BENEFITS	ANNUAL BENEFITS	Description and scale of key monetised benefits by 'main affected groups' Because the new regime is elective, AIFs will only elect in if the benefits exceed the costs.		
	One-off Yrs			
	£ tbc			
	Average Annual Benefit (excluding one-off)			
	£ tbc	Total Benefit (PV)	£ tbc	
Other key non-monetised benefits by 'main affected groups' The elective nature of the regime means that there should be a net overall benefit. At this stage, the precise scale of the benefits is difficult to determine as this will be influenced by the take up of the regime.				

Key Assumptions/Sensitivities/Risks

The key sensitivity relates to the estimated number of AIFs that choose to elect into the regime and the one-off costs of converting. However, as the regime is voluntary, the net benefits should be positive.

Price Base Year 2008	Time Period Years	Net Benefit Range (NPV) £ tbc	NET BENEFIT (NPV Best estimate) £ tbc
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What is the geographic coverage of the policy/option?	UK			
On what date will the policy be implemented?	tbc			
Which organisation(s) will enforce the policy?	HMRC			
What is the total annual cost of enforcement for these organisations?	£ Negligible			
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	£ tbc	Decrease of	£ tbc
Net Impact			£ tbc

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

Evidence Base (for summary sheets)

Background

Authorised investment funds (AIFs) are retail investment funds that are regulated by the Financial Services Authority. AIFs invest in a diversified portfolio of assets, including shares, securities, bonds and property with the aim of providing a return to their investors.

Implementing Tax Elective Funds (TEFs)

Note that for the discussion below, the option of doing nothing is considered as the base case, with all the costs and benefits assessed relative to status quo.

Costs

There are a number of costs that AIFs will incur for entering and remaining within the TEF regime. The most significant are one-off up-front costs for entering the regime, in particular:

1. IT costs for changing systems to comply with the TEF regime. These costs will vary according to the flexibility of existing systems and may also be shared due to single administrators covering multiple funds so the IT costs can be spread across multiple fund managers.
2. A fund electing to become a TEF will have to ensure that income remains identifiable as it passes through the fund to its investors. The Government acknowledges that this will lead to more complicated administration, however this is necessary to ensure that a new tax regime is balanced against ensuring sound public finances.

There will also be a one-off cost of giving notice to unit/share holders that the AIF is joining the regime.

Overall, the total cost of the TEF regime is sensitive to the number of AIFs that choose to elect into it. Dependent on this, the Government anticipates that the net additional ongoing cost to AIFs complying with the new elective tax regime will be small in aggregate.

The Government would welcome evidence from industry to aid with quantifying the costs outlined above.

Benefits

The TEF regime will be an elective regime, so in the case of any fund electing in, the fund managers (and implicitly the investors) will have made the assessment that the benefits to investors of the new regime outweigh the costs. As such, the expected value of the benefits outlined below will be greater than the costs outlined above, even if monetary amounts cannot be placed on these benefits.

UK AIFs are not generally subject to tax on gains from disposal of investment assets. In addition to this, the key benefit for AIFs that elect to be in the TEF regime is that, subject to conditions, they will not pay tax on investment income.

Competition Assessment

An important part of the industry's desire for changes to the tax rules is that they are currently prevented from competing for investors due to the way in which AIFs are currently taxed. By offering a new TEF regime that enables tax efficient investment into income producing assets investors should benefit from wider choices and more balanced asset portfolio investment. In this respect, the proposals should improve competition and ultimately create more efficient markets.

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	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
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

NEXT STEPS

5.1 The proposals set out in this tax framework are intended to form a basis for further discussions with the asset management industry. The Government welcomes comments on any aspect of the tax framework set out above.

5.2 The Government will continue to develop these proposals in parallel with work on the other areas of taxation for AIFs. These include reforming the stamp duty reserve tax legislation that applies to collective investment funds and replacing the substantial holding rule for the Qualified Investor Scheme, which were announced at Budget 2008, as well as considering the distinction between trading and investment. The Government is also continuing to consult on a modernised tax regime for offshore funds.

5.3 Interested parties should send their comments by Wednesday 22 October 2008 to:

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5.4 Subject to responses to this discussion paper, the Government intends to issue draft legislation for consultation before the end of the year, with the intention of introducing legislation in Finance Bill 2009.

Confidentiality Disclosure

5.5 Information provided in response to this discussion 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).

5.6 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

5.7 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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