

# Trading and investment for Authorised Investment Funds

---

December 2008



HM TREASURY





HM TREASURY

---

# Trading and investment for Authorised Investment Funds

December 2008

© Crown copyright 2008

The text in this document (excluding the Royal Coat of Arms and departmental logos) may be reproduced free of charge in any format or medium providing that it is reproduced accurately and not used in a misleading context. The material must be acknowledged as Crown copyright and the title of the document specified.

Where we have identified any third party copyright material you will need to obtain permission from the copyright holders concerned.

For any other use of this material please write to Office of Public Sector Information, Information Policy Team, Kew, Richmond, Surrey TW9 4DU or e-mail: [licensing@opsi.gov.uk](mailto:licensing@opsi.gov.uk)

## **HM Treasury contacts**

This document can be found in full on our website at:  
[hm-treasury.gov.uk](http://hm-treasury.gov.uk)

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4861

E-mail: [public.enquiries@hm-treasury.gov.uk](mailto:public.enquiries@hm-treasury.gov.uk)

Printed on at least 75% recycled paper.  
When you have finished with it please recycle it again.

ISBN 978-1-84532-548-0  
PU707

# Contents

---

|           |  | Page |
|-----------|--|------|
| Chapter 1 | Summary and introduction                       | 3    |
| Chapter 2 | Proposed legislative change                    | 7    |
| Annex A   | Proposed 'white list' of transactions for AIFs | 11   |



# 1

## Summary and introduction

---

### Summary

**1.1** The 2008 Pre-Budget Report announced the Government's intention to discuss with the industry the potential for introducing legislation to provide increased certainty about whether transactions carried out by Authorised Investment Funds (AIFs) are trading or investment. Following informal discussions with the Investment Management Association (IMA), this paper sets out proposals for such legislative change. The proposals include the introduction of a 'white list' of financial transactions, which when undertaken by AIFs meeting a genuine diversity of ownership test will not be taxed as trading, and also remove a 'precipice' in the current legislation whereby there is a risk that one trading transaction could bring the whole fund into tax as a financial trader.

### Introduction

**1.2** The Government is committed to ensuring 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, given both its direct contribution to the economy plus the vital role it plays in the performance of the broader economy by helping to unite those with capital to invest with profitable investment opportunities.

**1.3** Since December 2006, the Government has undertaken a joint programme of work with the IMA to enhance the competitiveness of the UK's asset management sector through improvements to the tax system. This work, which aimed to address the key themes highlighted in both the IMA/KPMG report *Taxation and the Competitiveness of UK Funds* and through broader dialogue with the industry, has included:

- Introduction of a new regime for the taxation of Property Authorised Investment Funds (Property AIFs);
- Discussion of possible reform of Schedule 19;
- Introduction of proposals for Tax Elected Funds (TEFs);
- A workstream on improving trust and understanding between the asset management sector and the Government, particularly on taxation;
- Simplification of the rules for the Qualified Investor Scheme (QIS).

**1.4** Uncertainty around the trading and investment boundary for UK funds was also raised in the IMA/KPMG report as an impediment to the further development of the UK asset management sector. This discussion paper sets out proposals for legislative change to address this issue, building on new guidance issued by HMRC at the 2007 Pre-Budget Report. Taken together with the tax policy changes set out above, these proposals form part of a package of measures to be finalised at Budget 2009 which will significantly improve the competitiveness of the UK asset management sector.

**1.5** The UK Government's main objective in 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.

**1.6** The proposed approach set out in this discussion paper of introducing a 'white list' of safe transactions and removing the cliff edge problem in the current legislation closely follows the approach taken in recent years in connection with the Investment Management Exemption (IME).

## Responding to the consultation

**1.7** Early in the New Year, the Government will publish draft legislation to introduce this 'white list' into law. Comments upon the 'white list' as set out in Annex A are welcome, in addition to comments on the draft legislation once published. Subject to responses, the Government intends to introduce the new legislation after Budget 2009.

**1.8** Comments are welcome either before draft clauses are published, or after publication. Interested parties should send their comments to:

Lee Harley  
HMRC,  
CT&VAT Product and Process,  
3<sup>rd</sup> Floor,  
100 Parliament Street,  
London, SW1A 2BQ.  
Telephone 020 7147 2597.  
Email: [lee.harley@hmrc.gsi.gov.uk](mailto:lee.harley@hmrc.gsi.gov.uk)

## Consultation disclosure

**1.9** 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).

**1.10** 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.

## 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

London

SW1A 2HQ

Telephone: +44 (0)20 7270 4558

Fax: +44 (0)20 7270 4681

E-mail: [public.enquiries@hm-treasury.gov.uk](mailto:public.enquiries@hm-treasury.gov.uk)



# 2

## Proposed legislative change

---

### Coverage

**2.1** The Government envisages the legislative change will apply to all AIFs meeting a “genuine diversity of ownership” test. This means that both UK tax resident authorised unit trusts and open ended investment companies, whether UCITs, NURS, or QIS<sup>1</sup>, will benefit from the change.

### Purpose

**2.2** Under UK tax law, there is currently a risk that if AIFs undertake certain transactions they could be considered to be trading for tax purposes, and therefore face being taxed accordingly.

**2.3** Being found to be trading would have a significant detrimental impact. Generally, AIFs are taxed only on their income and are not subject to tax on capital gains.

**2.4** But if, in relation to particular transactions, an AIF is held to be trading for tax purposes, the gains from those transactions will be taxed as income of that trade instead of being exempt from tax as capital gains. Furthermore, if particular transactions carried out by the AIF constitute trading for tax purposes, this can result in *all* of the AIF’s transactions being treated as trading for tax purposes.

**2.5** The main problem for AIFs stems from this uncertainty. The concern is not just that AIFs may be taxed as traders in relation to one or more transactions, but that the entire activity of the AIF could constitute trading and be exposed to tax because of the presence of certain transactions. This is referred to in this paper as the ‘precipice problem’.

**2.6** Given the increasingly innovative investment strategies undertaken by AIFs, the industry perceive that there is a growing danger that individual AIFs located in the UK could be found to be trading and taxed as such. Locating in other jurisdictions removes this problem, because other key jurisdictions such as Luxembourg and Ireland do not make the same distinction between trading and investment.

**2.7** At the 2007 Pre-Budget Report, HMRC published new guidance setting out more clearly the types of transactions that could be undertaken by any investment vehicle without being in danger of being considered to be undertaking a trade. This guidance was very well received by the asset management sector. However, despite the positive impact of the new guidance, legal uncertainty and therefore risk remains.

**2.8** The industry have been seeking greater certainty that AIFs will not be taxed as financial traders, and the Government is keen to respond given the potential impact on the UK’s competitiveness as a domicile of choice for asset management. Government has, in close dialogue with the IMA, considered the issue and proposes legislative change that will introduce

---

<sup>1</sup> Undertakings for Collective Investment in Transferable Securities (UCITS), Non-UCITS Retail Scheme (NURS), Qualified Investor Scheme (QIS).

a 'white list' of financial transactions which AIFs can undertake and have certainty that they will not be taxed as traders. This 'white list' aims to capture the range of financial transactions which AIFs are likely to undertake. The types of transactions the Government intends to include are detailed at Annex A.

## Introducing a 'white list' of financial investment transactions

**2.9** Following a similar model to that being adopted for the IME, the Government proposes to legislate a 'white list' of financial transactions. If an AIF which meets a "genuine diversity of ownership" test undertakes transactions on the 'white list', it will have certainty under the proposed legislation that it will not be taxed as trading in respect of those transactions. The Government intends the 'white list' to include as full a range as possible of financial transactions – more detail on the type of transactions that are proposed for inclusion is given in Annex A.

## 'Non-white list' transactions

**2.10** It should be noted that the proposed legislation will also 'ring fence' such 'white list' transactions for tax purposes. This means that 'white list' transactions will never be treated as trading and cannot be 'tainted' by other transactions carried out by the AIF – no matter what other transactions the AIF undertakes, the transactions on the 'white list' will be taxed as investment. On the other hand, if an AIF undertakes a transaction which does *not* appear on the 'white list', this will not automatically mean that that transaction will be considered to be trading. The characterisation of such transactions will be determined by applying general principles and will be considered by looking at the 'non-white list' transactions in isolation.

## Removing the precipice problem in the legislation

**2.11** In addition to certainty in respect of individual 'white list' transactions, the proposed legislative change also addresses the precipice problem. If an AIF meeting a genuine diversity of ownership test undertakes a 'non-white list' transaction, and that transaction is found to amount to trading, only that particular transaction will be taxed as a trading.

**2.12** The Government hopes this proposal will significantly reduce the uncertainty which AIFs may face under current rules.

## Protecting the public finances

**2.13** As well as enhancing the competitiveness of the UK asset management industry, the Government must also continue to ensure sound and sustainable public finances, and prevent unintended tax advantages being gained through investing through an AIF rather than through other channels. The proposals set out in this paper aim to strike a balance between giving AIFs clarity and certainty on what investment strategies they can safely pursue, whilst ensuring the new arrangements are not open to abuse.

**2.14** First of all, the introduction of a 'white list' limited to financial services transactions will help reduce the scope for abuse of the new provisions by trading entities seeking to reduce the amount of Corporation Tax they should pay.

**2.15** Second, the Government intends to introduce a 'genuine diversity of ownership' condition, which will help to prevent any abuse of the new provisions by limiting their benefit to funds which are made available to a wide range of investors. More specifically, the rule on genuine diversity of ownership aims to prevent small groups of persons coming together to form an AIF in order to benefit from the proposed provisions and to avoid paying the right amount of tax. The genuine diversity of ownership rule has been consulted on as part of the Qualified Investor Scheme rules for the AIF regulations which have recently been laid before Parliament.

**2.16** Third, the Government intends to introduce rules requiring existing financial traders (for example, banks or securities dealers) who acquire shares or units in AIFs benefiting from the proposed legislation, to recognise profits or losses on movements in the value of those shares or units in each taxable period and bring those profits or losses into account when computing the profits of their financial trade. This is to ensure that such financial traders cannot defer the point at which they are taxed in relation to their participation in the profits generated by the AIF. This rule will not affect the AIF itself, which will remain untaxed in relation to 'white list' transactions



# A Proposed 'white list' of transactions for AIFs

---

**A.1** This Annex sets out details of the types of transactions that will be included in the Government's proposed 'white list' of transactions which AIFs can undertake and still have certainty that they will not be taxed as financial traders.

**A.2** This 'white list' follows the model being adopted in the legislation governing the Investment Management Exemption (IME), which specifies categories of instruments, transactions in which are classed as "investment transactions". Although it is not the purpose of the IME legislation to re-characterise (income) trading transactions as (capital) investment transactions, the provisions achieve a similar outcome and are readily adapted to that task if applied to AIFs.

## What will be covered in a 'white list'

**A.3** Draft legislation on what will constitute an 'investment transaction' for UK AIFs will be published early in the New Year. The model for this legislation will be regulations setting out a revised 'white list' in the context of the IME. Those regulations are currently being drafted, but the Government's current intention is to include the following broad categories of transaction:

- Shares and stock;
- Loan relationships (including money deposits, loans and debt instruments);
- Derivative contracts (including futures, options, contracts for differences, swaps and warrants);
- Units in collective investment schemes;
- Securities of any description not included in the above categories;
- Buying or selling foreign currency; and
- Carbon emission credits.

**A.4** What follows is a brief discussion of each category.

## Shares and stock

**A.5** Government will simply adopt the statutory reference to "transactions in shares and stock", currently at section 127(12) FA 1995 and paragraph 3(3) Schedule 26 FA 2003. That legislation will be replaced by Regulations currently being prepared and expected to be published early in 2009, but the reference to "shares and stock" will remain unchanged.

## Loan Relationships

**A.6** Government will adopt the concept of "loan relationships" [cf. Chapter II Part IV FA 1996], encompassing a broad range of debt transactions.

**A.7** A “loan relationship” is defined at section 81 FA 1996 and subsists where a company stands (whether by reference to a security or otherwise) as either creditor or debtor as respects a money debt which results from a lending transaction. This admits all loans, including deposits, but excludes simple debts (e.g. trade debts, deferred purchase consideration etc). The definition is widened by section 81(3) to include all debts for which an instrument has been issued representing security for, or the rights of a creditor in respect of, the debt. This admits debentures, loan notes and other types of debt in note form, even though the debt may not have arisen from a lending transaction. The definition is narrowed by section 81(4) to exclude debts arising from rights conferred by shares in a company.

**A.8** AIFs, as actual or deemed companies, are already within the scope of the loan relationship regime and the concepts should therefore be familiar.

**A.9** The approach in respect of AIFs will be twofold. For the purposes of the ‘white list’, an extended definition of ‘loan relationship’ will be included to ensure that transactions in ‘simple’ debts (i.e. non-lending debts that are not in instrument form) are included in the non-trading safe harbour. This will enable AIFs to transact in portfolios of debt or receivables streams where these might not meet the FA 1996 definition of ‘loan relationship’. In addition, AIFs will be deemed to be party to all of their loan relationships other than for the purposes of a trade carried on by them, whilst retaining the existing carve-out for capital profits, gains and losses in regulation 10 SI 2006/964. The effect of this will be that the SORP will determine what profits, gains and losses constitute capital or income for tax purposes – without the need to consider the tax concept of “trade” – and only income profits will be subject to tax under Case III of Schedule D.

**A.10** This means that, regardless of the nature of the AIF’s activities, no profits, gains or losses from the AIF’s loan relationships or “related transactions” will be taken into account as trading profits in their own right. It will also mean that, where – exceptionally – the AIF carried on a trade in respect of other transactions (e.g. the purchase and sale of commodities), profits, gains and losses from its loan relationships will be prevented from being taken into account as part of the profits of that trade. In those exceptional circumstances, it may be necessary to provide that profits, gains and losses from loan relationships held directly for the purposes of that trade should continue to be taxed accordingly.

**A.11** The treatment outlined above could also be extended to those “alternative finance arrangements” within the meaning of Chapter 5 Part 2 FA 2005 that are treated as loan relationships by section 50 of that Act. Some alternative finance arrangements within those provisions require one party to the arrangement to be a “financial institution”, as defined by section 46(2) FA 2005, and it may be that this condition would prevent the arrangement qualifying in the hands of an AIF. In those circumstances, it may be necessary to modify the requirement in order to admit alternative finance arrangements that would otherwise qualify.

## **Derivative Contracts**

**A.12** The aim is to adopt the concepts applying for the purposes of the corporation tax Derivative Contracts regime at Schedule 26 FA 2002.

**A.13** Paragraph 2 Schedule 26 FA 2002 employs the concept of a “relevant contract”, which can be either:

- an option;
- a future; or
- a contract for differences (which includes swaps)

**A.14** Paragraph 12 Schedule 26 FA 2002 defines what is meant by these terms and further terms appearing in those definitions.

**A.15** Paragraph 12(8) defines an option to include a warrant (itself defined at sub-paragraph (9)) and paragraph 12(6) defines a future as a contract for the sale of property under which delivery is to be made at a future date and price; both of which are agreed when the contract is made. This definition includes forward contracts. Paragraph 12(10) stipulates that the definitions of an option or a future do not include contracts the terms of which provide only for cash settlement; but such contracts will be within the definition of “contract for differences”.

**A.16** Paragraph 12(3) defines a contract for differences and will include contracts for differences and swaps, whether the contract is by reference to property or an index. Paragraph 12(5) narrows the definition to exclude a future or option and certain other instruments such as insurance contracts and capital redemption policies.

**A.17** Paragraph 3(1) contains a general rule that a relevant contract can be a derivative contract for the purposes of Schedule 26 only if it is treated for accounting purposes as a derivative financial instrument.

**A.18** The approach in respect of AIFs will be twofold. For the purposes of the ‘white list’, an extended definition of ‘relevant contract’ will be adopted by disapplying some of the stipulations present in Schedule 26 FA 2002; for example, in relation to accounting requirements. This will ensure that transactions in a very wide range of derivative financial instruments are admitted to the non-trading safe harbour, meaning that AIFs will have certainty in relation to instruments which may not be ‘derivative contracts’ within the regime at Schedule 26 FA 2002. In addition, AIFs will be deemed to be party to all of their derivative contracts other than for the purposes of a trade, whilst retaining the existing carve-outs for capital profits, gains and losses in regulation 11 SI 2006/964. The effect of this will be that the SORP will determine what profits, gains and losses constitute capital or income for tax purposes – without the need to consider the tax concept of “trade” – and only income profits will be subject to tax under Case III of Schedule D as deemed non-trading loan relationship credits, by virtue of paragraph 14(3) Schedule 26 FA 2002.

**A.19** This will mean that that no profits, gains or losses from the AIF’s derivative contracts will be taken into account as trading profits in their own right. It will also mean that, where – exceptionally – the AIF carried on a trade in respect of other transactions (e.g. the purchase and sale of commodities), profits, gains and losses from its derivative contracts will be prevented from being taken into account as part of the profits of that trade. In those exceptional circumstances, it may be necessary to provide that profits, gains and losses from derivative contracts held directly for the purposes of that trade should continue to be taxed accordingly.

**A.20** The definition of relevant contracts for the purposes of the ‘white list’ and the deeming mentioned above will not extend to derivative contracts resulting in the physical delivery of non-financial assets (e.g. commodities); although futures and options which provide for the possibility of, but do not result in, physical settlement will be included.

**A.21** It is worth pointing out here that the exclusion of these contracts from the ‘white list’ and the deeming will not automatically result in transactions in such contracts being classified as trading; the question will simply remain to be determined on general principles on a case by case basis.

## **Units in Collective Investment Schemes**

**A.22** The proposal is to include transactions in units in collective investment schemes, within the meaning of section 235 Financial Services and Markets Act 2000.

## Securities of any description

**A.23** The proposal is to retain the existing reference (in the context of the IME) to transactions in “securities of any description”. The reference currently appears in the formula “transactions in shares, stock, futures contracts, options contracts *or securities of any description not mentioned in this paragraph*”. It will be necessary to modify the reference to exclude securities which are included in the preceding categories (e.g. loan relationships etc) so as to avoid duplication and the creation of otiose categories of transaction.

## Buying and selling foreign currency

**A.24** The intention is to simply adopt the existing statutory reference (in the context of the IME) to transactions “consisting in the buying or selling of any foreign currency”, currently at section 127(12) FA 1995 and paragraph 3(3) Schedule 26 FA 2003.

## Carbon emission credits

**A.25** The Government will simply adopt the definition currently in SI 2007/963 and 964.

**A.26** The Government has no objection to extending the definition to include other carbon emissions products.

## Other types of transactions

**A.27** Transactions other than those considered above will still be treated on their own merits. For example were an AIF to buy or sell ‘widgets’ then it could still be considered to be trading. However the classification of particular transactions or groups of transactions as trading (and so the profit as trading profit) will not ‘contaminate’ investment transactions within the AIF. The result here is that if an AIF ‘strayed’ into trading transactions then only those transactions will be subject to trading treatment for tax purposes.

ISBN 978-1-84532-548-0



9 781845 325480 >