

Tax elected funds: summary of responses

December 2008



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Contents

		Page
Chapter 1	Introduction	3
Chapter 2	Summary of responses	5
Annex A	List of respondents	11

1

Introduction

1.1 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 therefore a key priority for the Government. An efficient asset management sector plays a vital role in the performance of the whole economy by helping to unite those with capital to invest with profitable investment opportunities. The Government is also committed to ensuring that the UK retains its strength as a location for all aspects of asset management business.

1.2 Budget 2008 announced a package of measures to enhance the competitiveness of the UK as a place for funds to locate. One of the key proposals was that the Government would engage with industry to consider a direct tax exemption for Authorised Investment Funds (AIFs) based in the UK.

1.3 In July 2008 the Government published *Tax elected funds: a discussion paper*¹ setting out its proposals for a special, elective tax regime for UK funds. The Government is grateful for and has carefully considered the responses from interested parties to that discussion paper. The Government is particularly grateful to respondents who have provided assistance in developing the Tax Elected Fund (TEF) proposals to date.

1.4 As stated in the discussion paper, the Government's main objective in putting forward its 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.

1.5 The purpose of this document is to provide a summary of the responses received on the discussion paper and set out the Government's response to the key issues that were raised.

1.6 As the Government intends to publish draft regulations that will cover the points made in the paper in the new year, the Government is not inviting further comments at this stage. There will be an opportunity for people to give comments as part of the consultation on the draft regulations.

1.7 If you have any questions about this paper please contact Sue Harper (+44 (0) 20 7270 6031 sue.harper@hm-treasury.gov.uk).

¹ HM Treasury, July 2008.

2

Summary of responses

2.1 *Tax elected funds: a discussion paper* set out the Government's thoughts on how to create a special, elective regime for UK Authorised Investment Funds (AIFs). 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 if they owned the underlying assets directly. The AIF will remain a taxable entity.

2.2 The Government is grateful for the comments received from interested parties on the proposed tax framework. A summary of the key issues arising from the responses is contained below. A list of respondents to the discussion paper can be found in Annex A.

2.3 The majority of respondents welcomed the Government's engagement and the publication of *Tax elected funds: a discussion paper* and recognised that it represented one of the key proposals in the package of measures to enhance the competitiveness of UK funds. Some respondents raised concerns about the way in which the proposal sought to ensure that income remains identifiable as it passes through the funds to its investors. In particular, respondents were concerned that the level of administrative costs might outweigh the benefits associated with Tax Elected Funds (TEFs). The Government understands that significant administrative changes would be problematic for the industry and is therefore continuing to work with stakeholders to develop a regime that meets the Government's stated objectives and, to the extent possible, addresses the industry's concerns on administrative costs.

Authorised Investment Funds (AIFs)

2.4 Respondents welcomed the fact that the regime would apply to all AIFs.

Elective regime

2.5 The majority of respondents welcomed the elective nature of the TEF regime. The Government confirms that any AIF that meets the conditions will be able to elect to be a TEF.

2.6 Some respondents welcomed the certainty that an irrevocable election provides but would prefer a TEF to be permitted to exit the regime in a future period. The Government intends to respond to this point by including provisions in the legislation for a TEF that no longer wishes to maintain its TEF status.

Double taxation treaties

2.7 Many respondents requested reassurance on the impact of the TEF regime on access to double tax treaties for AIFs that do not elect into the new regime. As set out in the discussion paper, the Government confirms that the double taxation treaty position of funds that do not elect into the new regime should be unaffected by the introduction of TEFs.

2.8 Respondents also requested certainty on the double taxation treaty position for funds that elect to be TEFs. As set out in the discussion paper, 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.

Genuine diversity of ownership

2.9 Some respondents welcomed the genuine diversity of ownership condition. Other respondents questioned the purpose of the condition within the context of TEFs. The Government confirms that the purpose of this condition is to ensure that TEFs are made available to a wide range of investors and cannot be used to obtain unintended tax advantages, including the deferral or mitigation of tax on chargeable gains.

Tax treatment of income, gains and distributions

2.10 Some respondents proposed that TEFs should be exempt entities and not be liable to tax at all. The Government is not minded to take forward this proposal as it will not meet its stated objectives for the TEF regime. Respondents also expressed concern about the administrative changes that might be required to enable a fund to elect to be a TEF. Some respondents suggested that the Government should adopt a different approach and classify all income in the same way, depending on the composition of the fund's assets. This is covered in paragraphs 2.12 – 2.13 below. Other respondents commented about the complexity of the tax vouchers that would be required if income was to remain identifiable as it passed through the fund to its investors. Paragraphs 2.14 – 2.17 set out the Government's comments on the issue of tax vouchers. Some respondents also suggested that the way forward was to change the regulatory rules that specify that AIFs have to distribute the income in their distribution account every year. This is covered in paragraphs 2.18 – 2.19.

2.11 Paragraphs 2.20 – 2.27 set out a summary of responses to the specific types of income received within a TEF and the Government's comments.

Income streaming

2.12 Some respondents suggested that the Government should not require income to remain identifiable as it passes through the fund to its investors (income streaming). The alternative proposition was for all the income to be taxed on the investor in the same way, depending on the composition of the fund's assets. The Government is not minded to take this approach. It requires income to remain identifiable as it passes through the fund to its investors in order to deliver a competitive tax regime balanced against the need to ensure sound public finances.

2.13 However, the Government understands that one of the main issues that respondents were concerned about on income streaming was the complexity it would cause in terms of tax vouchers and investor understanding. The Government has listened to the industry's concerns on this matter and believes that it is possible to find a way forward which will deliver income streaming without requiring complex tax vouchers (see paragraphs 2.14 – 2.17). The Government also believes that it is likely that only two income streams will be required for TEFs, further simplifying the concept of income streaming (see paragraphs 2.20 – 2.27).

Tax vouchers

2.14 Mixed comments were received from respondents on the existing requirement for AIFs to issue tax vouchers and whether the current requirement should be retained within the TEF regime. Some respondents thought tax vouchers should be retained, in particular to facilitate investor understanding, while others thought that the inclusion of additional information on tax vouchers would cause real difficulties for funds which elected to be TEFs due to the requirement that income should remain identifiable as it passes through the fund to its investors.

2.15 The Government believes that it is right that an AIF which elects into the new regime must provide information to allow relevant investors to complete their self-assessments for tax purposes. However, the Government is willing to explore alternative investor communications other than the tax voucher requirement. For example, a TEF could include information on an investor's distribution letter in order to ensure that the investor has sufficient information to complete their self-assessment. This might mean the TEF's distribution letter follows similar requirements to those which are currently in place for corporate streaming.

2.16 In addition, the Government is considering, together with representatives from industry, the feasibility of funds providing a web-based facility which would allow investors to obtain a straightforward breakdown of their distribution for UK tax purposes.

2.17 The Government will continue to discuss these issues with industry before issuing its further proposals as part of the draft regulations.

Distributions

2.18 Some respondents suggested that the requirement for AIFs to distribute income every year should be removed for TEFs and investors should only be subject to tax on the eventual disposal of their investment (this is often referred to as gross roll-up). The Government is not minded to take forward this approach as part of the TEF regime as one of the Government's stated objectives is to balance the TEF proposals against the need to ensure sound and sustainable public finances. Gross roll-up does not deliver against this objective.

2.19 Some respondents commented that the TEF regime would be simpler if the regulatory requirement for AIFs to distribute the income in their distribution account each year was removed. The Government does not consider this to be necessary. AIFs which are income producing would, in any case, want to make distributions to their investors. AIFs that are designed for growth already issue accumulation units or operate reinvestment mechanics. And possible changes to the tax voucher requirement should reduce administration for some operators of reinvestment mechanics for AIFs which opt into the TEF regime. The Government does not, therefore, consider that the removal of the distribution requirement would be a helpful direction of travel for TEFs.

UK dividend income

2.20 No respondents directly commented on the Government's proposal that 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

2.21 Most respondents appreciated that the treatment of foreign dividends for investors was dependent on the Government's wider review of the treatment of UK corporate entities receiving foreign dividend income. PBR 2008¹ announced the Government would bring forward proposals for UK corporates receiving foreign dividend income as part of the ongoing consultation on Foreign Profits. Draft legislation² was then published on 9 December 2008.

2.22 The draft legislation proposes that foreign dividends received by medium or large entities based in the UK will be exempt from tax, subject to anti-avoidance provisions. It also specifies that all AIFs will be treated as medium or large for the purposes of the legislation. Subject to the

¹ 2008 Pre-Budget Report: Facing global challenges: Supporting people through difficult times, HM Treasury, November 2008.

² Draft clauses published on HM Revenue & Customs website, December 2008.

Government's further work on the reform of the tax rules for foreign dividends received by UK individuals (see paragraph 2.23 below), foreign dividends will therefore be included in the same income stream as UK dividends for the TEF regime. This will simplify the position for income streaming as there will only be the need for two streams.

2.23 As mentioned above, the Government is also currently working on the reform of the tax rules for UK individuals who receive dividends from overseas companies, including offshore funds. Foreign dividend tax reform for UK individuals is scheduled to be completed in Finance Bill 2009 and further details will be published in the new year.

Property investment income

2.24 Respondents recognised the rationale set out in the discussion paper on TEFs and property. Most respondents wanted the Government to allow a *de minimis* amount of property income to be received by a TEF which would, in particular, enable tracker funds to elect to be a TEF.

2.25 The Government would like to allow tracker funds to be able to elect into the TEF regime. It is therefore considering whether, bearing in mind the need to ensure sound public finances, it could provide a *de minimis* threshold for property held by a TEF. The Government intends to work closely with industry to determine how it can take this issue forward.

Other investment income

2.26 Most respondents agreed with the Government's proposal to treat interest and other investment income not otherwise specified as an interest distribution to investors.

Offshore income gains

2.27 Respondents recognised the issue of offshore income gains requires careful consideration for the TEF regime. Some respondents wanted the Government to work towards a 'notional income yield'. The Government acknowledges that the issue of how to deal with offshore income gains remains challenging and will continue to work with industry on the way forward.

Expenses

2.28 Mixed comments were received from respondents on expenses. Some respondents proposed that special rules for expenses should be included in the regulations and other respondents considered that they were not required because the current AIF rules do not specify how expenses should be allocated. The Government will continue to consider whether special rules will be required for allocating expenses within a TEF as the proposals develop.

Existing tax regimes

2.29 Many respondents considered that the bond fund regime³ should be retained to prevent funds having to make administrative changes to achieve a similar tax result. The Government agrees that it would be preferable to retain the bond fund regime and intends to do so. The Government will continue to consider the impact of the TEF proposals on the proposed elective tax regime for Funds of Alternative Investment Funds⁴.

³ The Authorised Investment Funds (Tax) Regulations 2006 No. 964.

⁴ *Funds of alternative investment funds: a tax framework*, HM Treasury, February 2008.

Breaching conditions

2.30 Respondents welcomed the inclusion of breaching conditions for non-compliance as part of the conditions for electing into the TEF regime. The Government intends to outline details of these conditions within draft regulations.

Transitional provisions

2.31 Respondents welcomed the Government's intention to include transitional provisions for AIFs wishing to elect to be a TEF.

A

List of respondents

A.1 The Government is grateful to the following organisations for their responses to “*Tax elected funds: a discussion paper*”

- Association of British Insurers
- Baillie Gifford & Co Ltd.
- BNP Paribas Securities Services
- British Property Federation
- City Fund Managers Group
- CMS Cameron McKenna LLP
- Deloitte & Touche LLP
- Ernst & Young LLP
- Eversheds
- Fidelity International
- Grant Thornton
- Herbert Smith LLP
- HBOS plc
- HSBC
- Investment Management Association
- JP Morgan Treasury and Securities Services
- Jupiter Asset Management Limited
- KPMG LLP
- Linklaters LLP
- Mazars LLP
- M&G Investments
- New Star Asset Management Group PLC
- NorthernTrust Bank
- PricewaterhouseCoopers LLP
- Skandia UK

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