

INVESTMENT TRUST COMPANIES: A TAX FRAMEWORK

Summary

1.1 Budget 2008 announced that the Government would consider adapting the tax rules for Investment Trust Companies to enable tax-efficient investment in a wider range of assets. This tax framework sets out the Government's thinking on how to deliver tax efficient investment into interest bearing assets and seeks industry's view on the proposed framework.

Background

1.2 Investment trust companies (ITCs) are pooled, risk-spreading investment vehicles constituted as limited liability companies. ITCs are publicly listed and invest in a diversified portfolio of shares and other securities with the aim of providing a return to their investors. There are currently around 230 ITCs in the UK with total assets under management of around £73 billion¹.

1.3 In order to be an ITC, a company must meet certain criteria set out in tax legislation². A company meeting the criteria is not subject to tax on chargeable gains and, among other conditions, must not retain more than 15 per cent of its income from shares and securities.

1.4 The issue of the taxation of ITCs was the subject of a report published in October 2007 by the Association of Investment Companies entitled "Delivering lower costs and innovation in pooled investments". The report argued that the UK tax rules acted as a barrier to ITCs being established in the UK. The report identified the main issue with the tax rules as being the absence of a tax-efficient method for UK based ITCs to invest in bonds.

1.5 Following that report, the Government announced in Budget 2008 that it would consider proposals to adapt the tax rules for ITCs to enable tax-efficient investment in a wider range of assets. This measure formed part of a package of measures designed to maintain the position of the UK as a competitive location for asset management.

1.6 The Government has now developed a tax framework for taking this issue forward. This will enable ITCs to invest in interest producing assets tax efficiently. The framework moves the point of taxation for interest bearing assets from the ITC to the shareholder, with the result that shareholders face broadly the same tax treatment as they would have had they owned the interest bearing assets directly.

1.7 The Government recognises that the Association of Investment Companies' report also favoured moving to a tax system that would allow tax-efficient investment in a wider range of asset classes other than equities and bonds, with a particular focus on property investment. The Government has already provided for tax-efficient investment in property for both open and closed-ended investment vehicles in the form of Property Authorised Investment Funds and UK-Real Estate Investment Trusts respectively. Given that tax-efficient property investment is already provided for and the challenges that including property as an asset class brings, the Government is not

¹ Source: *Delivering lower costs and innovation in pooled investments*, Association of Investment Companies, October 2007

² section 842 Income and Corporation Taxes Act 1988

minded to broaden the scope of the ITC regime to allow for tax-efficient investment in property at this point.

1.8 The Government's main aim in developing this framework is to allow UK based ITCs to invest tax-efficiently in bonds and other interest producing assets. The Government also aims to:

- ensure that UK investors continue to choose their investments for commercial rather than tax reasons;
- prevent unintended tax advantages being gained through investing in an ITC rather than direct investment; and
- implement this framework at no overall increase in cost to the UK Exchequer.

1.9 The key structural features of the proposed framework for ITCs are outlined below.

Optional regime

1.10 All ITCs will be able to opt into the proposed new tax regime to allow for tax-efficient investment in both bonds and equities. To align this with the existing tax rules for ITCs, an ITC will be required to inform HMRC, as part of the approval process for each accounting period, that it wishes to stream its distributions.

Interest investment income

1.11 ITCs are subject to corporation tax on interest income. The Government intends to deliver tax-efficient investment for ITCs in interest bearing assets by 'streaming' interest income.

1.12 To achieve this, the Government envisages that interest income will remain taxable in the ITC. The distribution of interest will then be deductible from corporation tax when paid to shareholders as an 'interest distribution'. The Government anticipates that the interest distribution will be treated as a payment of yearly interest and income tax at the lower rate will be deducted and accounted for by the ITC, unless the shareholder is entitled to receive gross payment of interest.

1.13 UK shareholders will be subject to the tax rules applicable to interest income at their normal rates.

1.14 Any interest income not distributed will be subject to corporation tax in the ITC. Any income not distributed in a period will be carried forward and distributed in a future period and this will be treated as a dividend distribution. This mirrors the tax treatment for ITCs not opting into this new regime.

1.15 To allow for flexibility, the Government does not intend that there should be a minimum level of investment into interest bearing assets to allow interest distributions to be made.

Other investment income

1.16 ITCs which choose to opt into the new regime will remain subject to corporation tax on all other taxable income received. This will be distributed, together with any

non-taxable income as dividends to investors. This mirrors the current tax position for ITCs.

Effects of change

1.17 The Government welcomes comments as to whether it is necessary to include transitional provisions for ITCs opting into the regime.

Impact assessment

1.18 The Impact Assessment (IA) is published within this document and should be read in conjunction with it. This is a consultation stage IA, which is reflected in the fact that there are, as yet, no quantitative estimates.

1.19 The Government will continue to undertake further analysis during the consultation period. The Government welcomes comments and evidence from interested parties to aid with the analysis used in this impact assessment.

Next steps

1.20 The Government intends to use this framework as a basis for discussions with the industry and its representative bodies. The Government welcomes comments from interested parties on the proposals set out in this tax framework.

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

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Assets, Savings & Wealth
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ
Tel: +44 (0) 20 7270 6031

E-mail: sue.harper@hm-treasury.gov.uk

A technical discussion paper and draft regulations will be developed subject to the responses to this tax framework.

Confidentiality Disclosure

Information provided in response to this tax framework, 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).

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 consultation has been conducted in accordance with the consultation criteria in the Department for Business Enterprise & Regulatory Reform Code of Practice. If you wish to access the full version of the Code, you can obtain it at

<http://bre.berr.gov.uk/regulation/consultation/code/>

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:

Richard Bowyer, Better Regulation and Policy Team
020 7147 0062 or richard.bowyer@hmrc.gsi.gov.uk.

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.

Summary: Intervention & Options		
Department /Agency: HM Treasury	Title: Impact Assessment of an optional tax regime for Investment Trust Companies	
Stage: Consultation Stage	Version: 1	Date: July 2008
Related Publications: "Investment Trust Companies: a tax framework" HM Treasury publication July 2008		

Available to view or download at:

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

Contact for enquiries: Sue Harper

Telephone: 020 7270 6031

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

Investment Trust Companies (ITCs) are pooled, risk-spreading investment vehicles constituted as limited liability companies. Currently investors in ITCs that hold interest bearing assets can face a different tax treatment than if they had invested into a bond or other interest bearing asset directly.

What are the policy objectives and the intended effects?

The policy objective is to ensure that ITCs can invest more tax-efficiently into interest bearing assets.

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

1. Do nothing - this would mean that investors would continue to face a different tax treatment than if they had invested in the underlying assets directly.
2. Introduce a tax framework to allow tax efficient investment into interest bearing assets - this would mean that investors would face broadly the same tax treatment as if they had invested in the underlying interest bearing asset 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 2008

Summary: Analysis & Evidence

Policy Option: 2	Description: Introducing tax framework to allow tax efficient investment into interest bearing assets.
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COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups' ITCs opting into the new regime will incur one off costs. These include operational costs from adapting systems to the 'streaming' rules; costs incurred to familiarise with the new rules and the costs of information and disclosure to shareholders. ITCs opting in will also incur on-going costs from operating 'streaming'.
	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 optional, ITCs will only opt 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' None			

Key Assumptions/Sensitivities/Risks The optional nature of the proposed regime means that there should be a net overall benefit. The precise scale of the benefits is difficult to determine as this will be influenced by the take up of the regime.

Price Base Year	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

Investment trust companies (ITCs) are pooled, risk-spreading investment vehicles constituted as limited liability companies. ITCs are publicly listed and invest in a diversified portfolio of shares and other securities with the aim of providing a return to their investors. There are currently around 230 ITCs in the UK with total assets under management of around £73 billion.

The issue of the taxation of ITCs was the subject of a report published in October 2007 by the Association of Investment Companies entitled “Delivering lower costs and innovation in pooled investments”. The report argued that the UK tax rules acted as a barrier to ITCs being established in the UK. The report identified the absence of a tax efficient method for UK based ITCs to invest in bonds as being the main issue.

Implementing a new optional tax regime for ITCs

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

Costs

There are costs that ITCs will incur for opting into and complying with the proposed regime.

IT costs will be incurred for changing systems to comply with the new regime. These costs will vary according to the flexibility of existing systems and may also be shared due to single administrators covering multiple ITCs, so the IT costs can be spread across a number of ITCs. At present the Government does not have sufficient information to estimate the likely magnitude of these costs.

ITCs will also incur costs from having to notify their investors of their decision to opt into the new tax regime (and in some cases ITCs may need to seek shareholder approval). This will tend to be a ‘one off’ cost for ITCs, which may be reduced if the decision is amalgamated with other business that requires notifications or shareholder approval.

ITCs opting in may also incur some ongoing costs from operating ‘streaming’, for example in reporting the split of distributions paid to investors by income stream.

Overall, the total cost of the regime is sensitive to the number of ITCs that choose to opt into it. In practice take-up will not be known until after the regime is introduced.

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

Benefits

The Association of Investment Companies’ assessment is that ITCs are effectively excluded from investing in bonds due to the existing tax rules. This is evidenced by the fact that only a very small proportion of ITC businesses invest in bonds and that new ITCs wishing to invest into these assets are located offshore.

The key benefits of the Government’s proposals stem from the opportunity they provide for ITCs to compete for new business in bond investments. Increased competition should improve choice for investors. ITCs and their investors will have a wider range of asset classes to invest in tax-efficiently. Small investors in particular will benefit from being able to access professional investment expertise in interest bearing assets through closed-ended investment companies.

Overall, given that the new tax regime will optional, ITC managers (and implicitly investors) will only opt into the new regime if they forecast that the benefits of streaming outweigh the costs.

Competition Assessment

An important part of the industry's case for changes to the tax rules is that they are currently prevented from competing in the market for interest bearing assets. By offering investors the opportunity to hold interest bearing assets through a tax-efficient ITC, the proposal effectively widens investor choice. In this respect, the proposal should improve competition for bond investment and ultimately more efficient markets.

Small Firms Impact

ITCs span a range of business sizes. The proposals will enable all existing and new ITCs to opt into the new tax regime. Costs and benefits may vary to some degree according to the size of the ITC and their investment strategy. The Government has no information to suggest that smaller ITCs will be affected disproportionately.

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

