

## EXPLANATORY NOTE

### CLAUSE 16: OPEN-ENDED INVESTMENT COMPANIES

#### SUMMARY

1. Clause 16 sets out the rate of corporation tax that applies to open-ended investment companies (OEICs).

#### DETAILS OF THE CLAUSE

2. The clause introduces new section 468A into Income and Corporation Taxes Acts 1988 (ICTA). The new section sets out a special rate of corporation tax for OEICs and how that rate applies for an OEIC that is an ‘umbrella company’.
3. New section 468A(1) ICTA sets the special rate of corporation tax for OEICs as equivalent to the lower rate of income tax. It also provides that neither the small companies’ rate nor the corporation tax starting rate can apply to OEICs.
4. In subsection (2) of new section 468A ICTA, an OEIC is defined for the purposes of new section 468A as a UK-incorporated company to which section 236 Financial Services and Markets Act 2000 applies.
5. Subsection (3) of new section 468A ICTA deals with the corporation tax rate applicable to an ‘umbrella company’. For this purpose, ‘umbrella company’ is defined in subsection (4) as an OEIC that operates a number of separate investment pools for different groups of customers. The profits from one of these pools, or parts of the company, can be distributed only to the investors in that pool, but investors can switch between pools.
6. The special OEIC corporation tax rate applies to each of the separate parts of the umbrella company, and for this purpose, the umbrella company itself is not regarded as an OEIC, and will only be regarded as a company where expressly provided for elsewhere in the Tax Acts.

**BACKGROUND NOTES**

7. As part of the package of reforms to the tax regime for authorised investment funds (OEICs and authorised unit trusts (AUTs)), the Finance Bill includes powers to rationalise the existing legislation that applies to these funds. The first step towards this is to add a basic charging clause in primary legislation to cover OEICs, similar to that for AUTs at section 468 ICTA. This provides for the trustees of an AUT to be chargeable to tax at a rate equivalent to the lower rate of income tax (currently 20%).
8. OEICs are corporate versions of AUTs and in virtually all respects the tax treatment of the two vehicles is the same. But OEICs are companies and without special provision, would be taxable at the normal corporation tax rate of 30% (or at lower rates depending on their size). To maintain similar treatment with AUTs, it is necessary to specify that a reduced rate of corporation tax applies to these vehicles which this clause does.

## EXPLANATORY NOTE

### CLAUSE 17: AUTHORISED UNIT TRUSTS AND OPEN-ENDED INVESTMENT COMPANIES

#### SUMMARY

1. Clause 17 puts in place measures needed to rationalise the existing tax regime for authorised investment funds (authorised unit trusts (AUTs) and open-ended investment companies (OEICs)) and to introduce changes to that regime in response to recent regulatory reforms for these vehicles. The clause provides powers to establish the rationalised and up-dated regime by regulations.

#### DETAILS OF THE CLAUSE

2. Subsection (1) repeals various sections of the Tax Acts relating to the operation of the tax regime for UK resident AUTs and OEICs that will be restated as part of the regulation-based regime.
3. Subsection (2) defines ‘authorised investment funds’ (AIFs) as authorised unit trusts and open-ended investment companies. These terms are defined in subsection (4).
4. Subsection (3) provides powers to modify in regulations taxation provisions that apply to AIFs themselves, transactions involving AIFs and investors in AIFs. The power also extends to imposing requirements on fund managers to provide information, keep records and in relation to other administrative matters.
5. Subsection (4) defines the main terms used in this Chapter.

#### BACKGROUND NOTES

6. A package of reforms to the tax regime for authorised investment funds (OEICs and authorised unit trusts (AUTs)) to reflect recent regulatory changes was announced at Budget 2005. The Finance Bill includes powers to introduce a regulations-based regime that brings in the reforms, and at the same time rationalises the existing legislation that applies to these funds. This clause sets out the basic mechanisms necessary to do that.

## EXPLANATORY NOTE

### CLAUSE 18: SECTION 17(3): SPECIFIC POWERS

#### SUMMARY

1. Clause 18 gives particulars of how the powers provided for in clause 17 can be used. These powers are to enable reform and rationalisation of the tax regime for authorised investment funds (authorised unit trusts (AUTs) and open-ended investment companies (OEICs)) to be accommodated in regulations.

#### DETAILS OF THE CLAUSE

2. Subsection (1) sets out eight specific ways in which the powers provided in subsections (3)(a) and (3)(b) of clause 17 can be used in relation to distributions of authorised investment funds (AIFs). They allow regulations to be made that provide for the following:

Subsection (1)(a): to require an AIF to apportion distributable profits between amounts treated as yearly interest and as dividends in a prescribed way;

Subsection (1)(b): to permit, on election, an AIF to make only dividend distributions for tax purposes;

Subsection (1)(c): to require an AIF's distribution account to show amounts available for distribution as dividends and/or yearly interest;

Subsection (1)(d): for amounts distributed as yearly interest to be allowed as deductions in computing the AIF's profits;

Subsection (1)(e): to make provision to determine the distribution date of an AIF;

Subsection (1)(f): to permit distributions to be made without deduction of tax where the owner of the unit or share is not ordinarily resident in the UK;

Subsection (1)(g): to prescribe circumstances when distributions can be made to UK resident owners of units or shares without deduction of tax;

Subsection (1)(h): to make provisions regarding the tax treatment of distributions in the hands of corporation tax payers.

3. Subsection (2) sets out three specific ways in which the powers provided in subsections (3)(a) and (3)(b) of clause 17 can be used in relation to loan relationships and derivative contracts in connection with AIFs.

Subsection (2)(a) and (2)(b) allow special rules to be made in connection with loan relationships and derivative contracts held by an AIF. These rules are currently found in paragraphs 2A and 2B Schedule 9 Finance Act (FA) 1996 and paragraphs 32 to 34 Schedule 26 FA 2002. They allow for the capital profits or losses to be excluded from the amounts brought into account as credits or debits.

Subsection 2(c) applies to corporation tax payers that own units or shares in AIFs. It allows modifications to be made to the definition of ‘relevant holding’ for the purposes of paragraph 4 Schedule 10 FA 1996 and paragraph 36 Schedule 26 FA 2002. In some circumstances, these two paragraphs treat a corporation tax payer’s holdings of units or shares in an AIF as a loan relationship or derivative contract.

Subsection (2)(d) provides for powers in relation to umbrella schemes. Umbrella schemes are umbrella companies and their AUT-equivalent, umbrella funds.

Subsection (2)(e) allows for the introduction of a non-discrimination clause to those holding different classes of units or shares in an AIF.

4. Subsection (3) allows for provision to be made under subsections (a) or (b) of clause 17 for a different tax treatment to certain kinds of investors in certain kinds of AIFs.

Subsection (3)(a) restricts the different tax treatment to the beneficial owners of units or shares in a special type of AIF known as a Qualified Investor Scheme (QIS). These schemes are open only to ‘sophisticated investors’, companies and other kinds of institutional investors.

The different tax treatment is further restricted to investors who alone or together with associates or connected parties hold 10% or more of the units or shares in a QIS. The percentage can be varied from the stated 10%.

Subsection (3)(b) sets out a range of owners of units to whom the different tax treatment will not be applied. These include charities, registered pension schemes and life assurance companies (including Friendly Societies). This subsection also allows further exclusions to be made in regulations.

5. Subsection (4) provides powers to require managers of AIFs to provide information and make available books and records to HM Revenue and Customs.
6. Subsection (5) allows for regulations to repeal and to make any incidental, consequential, supplemental or transitional provisions that may be required.

### **BACKGROUND NOTES**

7. A package of reforms to the tax regime for authorised investment funds (OEICs and authorised unit trusts (AUTs)) to reflect recent regulatory changes was announced at the Budget. Finance Bill 2005 includes powers to introduce a regulations-based regime that brings in the reforms, and at the same time rationalises the existing legislation that applies to these funds. Clause 17 sets out the basic powers that can be used. This clause sets out more detail of the particular uses to which the powers can be put.
8. In particular, the clause provides for the introduction of a rule that taxes as income the annual changes in value of fund holdings for investors who own 10% or more of a Qualified Investor Scheme.

## **EXPLANATORY NOTE**

### **CLAUSE 19: SECTION 17: COMMENCEMENT AND PROCEDURE**

#### **SUMMARY**

1. Clause 19 sets out when clause 17 comes in to effect. This clause repeals some of the existing legislation that applies to authorised investment funds (authorised unit trusts (AUTs) and open-ended investment companies (OEICs)). It also sets out the procedures for making regulations under the powers provided by clause 17 of this Finance Bill. These powers allow regulations to be made regarding the taxation of authorised investment funds (AIFs), investors in those funds and the fund managers.

#### **DETAILS OF THE CLAUSE**

2. Subsection (1) states that repeals covered by clause 17 are effective from a day appointed by order of the Treasury.
3. Subsection (2) allows an order under subsection (1) to provide for the repeals listed in clause 17 to take effect on different dates and to cover savings.
4. Subsection (3) sets out that generally, regulations made under clause 17 will be subject to the negative resolution procedure.
5. Subsection (4) sets out the exception and requires an affirmative resolution the first time powers under clause 17 are exercised.

#### **BACKGROUND NOTES**

6. A package of reforms to the tax regime for authorised investment funds (authorised unit trusts and open-ended investment companies) to reflect recent regulatory changes was announced at Budget 2005. Finance Bill 2005 includes powers to introduce a regulations-based regime that brings in the reforms, and at the same time rationalises the existing legislation that applies to these funds. Clauses 17 and 18 set out how the powers can be used. This clause sets out commencement details for the reformed and rationalised regime, and the procedures for making the regulations.

## EXPLANATORY NOTE

### CLAUSE 20: UNAUTHORISED UNIT TRUSTS: CHARGEABLE GAINS

#### SUMMARY

1. Clause 20 amends provisions in the Taxation of Chargeable Gains Act 1992 (TCGA) which determine the circumstances in which capital gains and losses realised on the disposal of investments held by unauthorised unit trusts are excluded from the scope of capital gains tax. (Unauthorised unit trusts are unit trust schemes which are not authorised unit trusts.) The amendments have effect for the tax year 2005-06 onwards.

#### DETAILS OF THE CLAUSE

2. Subsection (1) provides for section 100 of the TCGA to be amended in accordance with the provisions made by subsections (2) and (3). Section 100 provides for capital gains arising to certain kinds of investment funds (such as unit trust schemes and investment trusts) not to be chargeable gains. This has the effect that no United Kingdom tax is charged in respect of such gains, and also that capital losses realised by the funds are not allowable losses. (The significance of a loss being an “allowable loss” is that it can be set off against chargeable gains. Unused allowable losses can be carried forward to be set off against chargeable gains arising in the future.)
3. Subsection (2) inserts two new subsections, subsections (2A) and (2B), into section 100. These provisions are supplementary to subsection (2) of that section, which provides that capital gains which arise to an unauthorised unit trust in a tax year are not chargeable gains if a condition is met. The condition is that throughout the year all the units in issue must be held by persons who would be wholly exempt from capital gains tax or corporation tax on any capital gain arising if they were to dispose of their units. The condition is not met if the reason for the exemption in the case of any unit holder is the residence status of that person for tax purposes.

4. Subsection (2A) of section 100 applies where units in an unauthorised unit trust have been disposed of by a unit holder and are held by the fund managers pending disposal to an investor. The subsection provides that, for such times as the units are held by the managers in their capacity as such, no account is taken of those units for the purposes of determining whether subsection (2) of section 100 applies in relation to the unit trust.
5. Subsection (2B) of section 100 applies where units in an unauthorised unit trust are held by an insurance company (within the meaning of section 431 of the Income and Corporation Taxes Act 1988 (ICTA)), an incorporated friendly society or a registered friendly society (within the meaning of section 466(2) ICTA). It provides that, for the purpose of determining whether subsection (2) of section 100 applies in relation to the unit trust, no account is to be taken of the possibility that a charge to corporation tax on income might arise in respect of any capital gains arising to such a unit holder on the disposal of its units.
6. Subsection (3) of the clause provides the commencement for the changes made by subsection (2): they are to apply for the tax year 2005-06 onwards.

### **BACKGROUND NOTES**

7. Authorised unit trusts are not chargeable to tax in respect of capital gains arising on disposals of their investments. Although this is not generally the case for unauthorised unit trusts, section 100(2) of the TCGA provides that an exception is made in the circumstances described in paragraph 3 above.
8. Capital gains arising to unauthorised unit trusts are not chargeable gains in cases where all the units are held by bodies, such as pension funds, charities and local authorities, which are wholly exempt, by reason other than residence, from tax in respect of capital gains arising on disposals of their investments.
9. The fund managers of a unit trust scheme may operate a “box”, an arrangement which enables them, in their capacity as managers of the scheme, to hold units in the unit trust which they have acquired from one investor pending their sale to another investor. Such an arrangement avoids the necessity of units having to be cancelled when an investor no longer wishes to hold them if there is an expectation that another existing investor, or a potential future

investor, will wish to acquire them. Where the managers of an unauthorised unit trust hold any of its units in such circumstances the condition for the unit trust's gains not to be chargeable gains is not met if any gain arising to the managers on the disposal of those units would not be wholly exempt from capital gains tax or corporation tax.

10. A HM Revenue and Customs Extra-statutory Concession (ESC D17) provides, however, for such temporary holding of units by the managers of an unauthorised unit trust to be disregarded for the purposes of determining whether the condition for the unit trust's gains not to be chargeable gains is met. The measure described in paragraph 4 above gives statutory effect to the concession, which will not, therefore, apply in relation to any tax year after 2004-05.
11. The measure described in paragraph 5 above will secure that life assurance companies and friendly societies whose capital gains are exempt from corporation tax on chargeable gains can now become investors in unauthorised unit trusts dedicated for investors which are exempt from tax on capital gains in respect of their investments without "tainting" the unit trust. Under existing law, if capital gains arising to such a company on a disposal of units in an unauthorised unit trust would be taken into account in calculating the company's liability to corporation tax on income, the condition for the unit trust's gains not to be chargeable gains would not be met. That is because the company would not satisfy the requirement of being wholly exempt from corporation tax on the gains realised on the disposal even though those gains would be exempt from the corporation tax charge on capital gains.

**EXPLANATORY NOTE****CLAUSE 21: UNIT TRUSTS: TREATMENT OF ACCUMULATION UNITS****SUMMARY**

1. Clause 21 gives statutory effect to a HM Revenue and Customs practice in relation to the reinvestment, in respect of accumulation units, of income from the investments of a unit trust. It provides, in certain circumstances, for sums reinvested in this way by the trustees of a unit trust scheme on a unit holder's behalf in respect of his accumulation units to be treated as amounts of expenditure incurred in enhancing the value of the units which are allowable as deductions in the computation of any chargeable gain or loss arising on a disposal of the units. The provision has corresponding effect in relation to accumulation shares in open-ended investment companies. The clause applies in relation to disposals of accumulation units or shares on or after 16 March 2005.

**DETAILS OF THE CLAUSE**

2. Subsection (1) inserts a new section, section 99B, into the Taxation of Chargeable Gains Act 1992 (TCGA), and subsection (2) makes commencement provision.

*Section 99B TCGA Calculation of the disposal cost of accumulation units*

3. Subsection (1) has effect to provide that, for the purposes of computing any chargeable gain arising to a unit holder on a disposal by him of units in a unit trust scheme, and for the purposes of all other provisions of the TCGA, certain amounts are treated as expenditure wholly and exclusively incurred by him on the units in order to enhance their value. It also has effect to provide that, for those purposes, such expenditure is regarded as being reflected in the state or nature of the units at the time of the disposal. Although subsection (1) refers only to the computation of gains, section 16(1) provides that the measure has exactly the same effect in relation to the computation of capital losses.

4. The significance of the treatment provided by subsection (1) is that any chargeable gain arising on the disposal of accumulation units is reduced by the aggregate of such “enhancement expenditure”, and any allowable loss arising on such a disposal is increased by the aggregate of such expenditure. In order for an amount to be treated in this way, the three conditions set out in paragraphs 5 to 7 below must be satisfied in relation to it.
5. The first condition is that the amount represents income from the investments of the unit trust.
6. The second condition is that the amount has been reinvested on the unit holder’s behalf in respect of the units being disposed of without new units having being issued.
7. The third condition is satisfied if the amount is charged to tax as income in the hands of the unit holder, or would be so charged but for the effect of a relief. The condition is also satisfied if the amount is taken into account as a receipt in calculating the unit holder’s profits, gains or losses for the purposes of tax on income.
8. Subsection (2) determines the date on which an amount which is treated as though it were enhancement expenditure incurred on the units in accordance with subsection (1) is treated for TCGA purposes as having been so incurred. For an authorised unit trust, this is the “distribution date” for the “distribution period” in respect of which the amount was reinvested as described in paragraph 6 above. For any other unit trust, it is the date when the amount in question was reinvested.
9. Subsection (3) provides interpretation for the references in subsection (2) to “distribution date” and “distribution period”.

### BACKGROUND NOTES

10. Where a unit trust scheme distributes income from its investments to its unit holders, the unit holders are chargeable to income tax or, as the case may be, corporation tax in respect of those distributions. Some unit trusts have accumulation units. Amounts of income from a unit trust’s investments are not distributed to holders of its accumulation units. Instead, such amounts which are referable to accumulation units are reinvested by the trustees on behalf of the unit holders concerned without any new units being issued. This has the effect of increasing the value of the

accumulation units, and the unit holders are chargeable to income tax or, as the case may be, corporation tax as though they had received distributions of the amounts concerned.

11. Where a unit holder disposes of accumulation units, HM Revenue and Customs long-standing practice has been to treat any amounts reinvested as described above as being deductible in the computation of any capital gain or loss arising on the disposal. The measure introduced by this clause gives statutory effect to that practice.
12. The new provision will apply in relation to accumulation shares in an open-ended investment company in the same way as it applies in relation to accumulation units in an authorised unit trust. This is by virtue of the Open-ended Investment Companies (Tax) Regulations 1997 (SI 1997/1154).

**EXPLANATORY NOTE****CLAUSE 22: SECTION 349B ICTA: EXEMPTION FOR DISTRIBUTIONS TO PEP/ISA MANAGERS****SUMMARY**

1. Clause 22 removes the leg of the statutory test at section 349B(4) Income and Corporation Taxes Act 1988 (ICTA) that allows a corporation tax payer to pay interest gross to a PEP/ISA Plan Manager if it “reasonably believes” that the underlying investor is entitled to exemption from tax on the interest. The revised test will require the payer to “reasonably believe” only that payment is being made to a PEP/ISA Plan Manager, in respect of Plan Investments. Responsibility for any tax on interest on a void account (that is one where the investor is no longer entitled to receive the income gross) will now fall to the recipient of the interest. These changes apply equally to Child Trust Fund (CTF) Providers.

**DETAILS OF THE CLAUSE**

2. Subsection (1) introduces the amendment to section 349B(4) ICTA.
3. Subsection (2) inserts new words in section 349B(4)(a) to define the plan referred to in the section as a PEP or ISA Plan. This ensures that the payer needs to “reasonably believe” only that the payment is being made to a PEP or ISA Plan Manager, and that the payment relates wholly to Plan Investments. He need no longer satisfy himself that the underlying investor is entitled to receive interest payments gross. The same applies to AIFs paying a CTF Provider by virtue of regulation 24 (c) of the CTF regulations (SI 2004/1450).
4. Subsection (3) removes section 349B(4)(b) as it is no longer required following the change introduced by subsection 2 of this clause.

5. Subsection (4) sets the commencement date by stating that the change will apply to payments of interest made to PEP/ISA or CTF Plan Managers on or after 6 April 2005.

### **BACKGROUND NOTES**

6. This change is being made in response to industry lobbying that the test for paying interest gross to PEP/ISA Plans is difficult to comply with in practice, as the payer may not be notified for some time that an investor's account has become void for some reason. Once the account becomes void, the investor is no longer entitled to receive payments of interest without deduction of income tax. A number of incorrect gross payments may therefore be made, which under current rules, the payer is afterwards required to rectify.

**EXPLANATORY NOTE****CLAUSE 23: OFFSHORE FUNDS****SUMMARY**

1. Clause 23 corrects some minor defects in the legislation in Chapter V of Part XVII of the Income and Corporation Taxes Act 1988 (ICTA), which deals with the taxation of income and certain gains derived from, or arising on the disposal of, investments in offshore funds. The minor defects are the omission of consequential amendments to cross-references to provisions in the Taxation of Chargeable Gains Act 1992 (TCGA) amended by legislation introduced in Finance Act (FA) 2003, and the omission of certain consequential amendments which should have been made when the loan relationships legislation was introduced in FA 1996. The corrections take account of the enactment of the Income Tax (Trading and Other Income) Act 2005 (ITTOIA) as part of the Tax Law Rewrite programme.

**DETAILS OF THE CLAUSE**

2. Subsection (1) updates the cross-references in section 761 ICTA, which covers the charge to tax on offshore income gains, to reflect changes to provisions in TCGA made by FA 2003.
3. Subsection (2) updates paragraph 1(1)(d) of Schedule 27 ICTA, which includes requirements to be met if an offshore fund is to be regarded as pursuing a full distribution policy, to take account of certain consequential amendments to ICTA made when the loan relationships legislation in Chapter II of Part IV of FA 1996 was enacted and the introduction of ITTOIA.
4. Subsection (3) updates paragraph 3(1)(a) of Schedule 27 ICTA, which defines certain sums which are to be treated as part of a distribution made by an offshore fund, to take account of certain consequential amendments to ICTA made when the loan relationships legislation in Chapter II of Part IV of FA 1996 was enacted and the introduction of ITTOIA.

5. Subsection (4) makes a consequential amendment to paragraph 3(1)(b) of Schedule 27 ICTA to reflect the above change.

**BACKGROUND NOTES**

6. These changes are being made to ensure the offshore funds legislation includes the correct cross-references to other parts of tax law. These cross-references should have been updated when FA 2003 introduced the concept of a permanent establishment of a company into UK tax law and when the loan relationships legislation was introduced in FA 1996. The updating now also takes account of the changes to the language used in income tax law made in ITTOIA.