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A legal update from Dechert's Tax Group

HM Treasury Publishes Consultation Papers to Make Authorised Investment Funds More Competitive and Tax-Efficient

The UK government has published three consultation papers aimed at reforming the tax frameworks for Authorised Investment Funds, Qualified Investor Schemes and Investment Trust Companies in an attempt to make them more competitive with non-UK funds.

Authorised Investment Funds (AIFs)

HM Treasury has issued proposals intended to make UK AIFs competitive with non-UK funds by moving the point of taxation from the AIF to the investor. The intention is for the investors to face broadly the same tax treatment as if they owned the underlying assets directly. The proposals would apply to all AIFs including authorised unit trusts, UCITS, Non-UCITS Retail Schemes and Qualified Investor Schemes. This contrasts with the existing position whereby AIFs are subject to tax at 20% on certain types of income (after management expenses and double tax relief).

The government intends to permit AIFs to irrevocably elect to become a Tax Elected Fund (TEF). Once elected, the TEF would need to ensure that different streams of income remained identifiable as they passed through the fund. Certain streams, such as interest, UK dividend and foreign investment income, will not be taxed at the level of the fund. However the TEF will not be treated as tax transparent so the investor will not be able to gain credit for any foreign tax paid.

Following the recent introduction of the Property AIF (PAIF), the government does not currently intend to allow a TEF to invest in property as it considers the PAIF to be the proper vehicle for this. As yet, the government has not produced proposals as to how to treat gains made from the TEF investing in non-UK funds (offshore income gains) but invites comments as to how this should be achieved. The current tax regime for Funds of Alternative Investment Funds ("FAIF") exempts such gains but at the cost of the investor being subject to income tax on any gains made on redemption of its interest in the FAIF. This is unattractive due to the significant tax rate differential between income (40%) and gains (18%), and so another solution needs to be found.

The government admits that the need to identify different income streams will impose an additional administrative burden. Whilst it is not intended that becoming a TEF will affect a fund's access to the UK's network of double taxation treaties, this will depend to a certain extent as to how TEFs are viewed in other jurisdictions.

In order to qualify as a TEF, an AIF will need to meet a further genuine diversity of ownership condition (similar to that required of PAIFs).

Qualified Investor Schemes (QIS)

A QIS is an AIF qualifying under a regime introduced in 2004 and regulated by the FSA. Currently, QISs are subject to a substantial holding rule so that any investor who holds more than a 10 % holding in a QIS will be subject to a tax charge. The government has released draft regulations that would replace this substantial

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holding rule with a requirement that the QIS should instead have a genuine diversity of ownership.

The genuine diversity of ownership rules differ from the current approach in that they are more concerned with the marketing and documentation of the fund than with its ownership. The QIS's prospectus must make clear both who its eligible investors are and that shares are open to all such investors. The manager must continue to market the fund to its eligible investors.

The government proposes to look through feeder funds to their investors in determining whether the genuine diversity of ownership test has been met.

Currently, the substantial holding rule does not apply to certain categories of participants, such as insurance companies. However, it is intended that the new rules will operate across all funds regardless of the category of investor.

Investment Trust Companies (ITCs)

ITCs are collective investment schemes structured as limited liability companies that, in return for complying with certain conditions, are not subject to tax on capital gains but are subject to corporate tax on income at 20%. The new government proposals are designed to enable ITCs to opt into a new regime that will allow them to invest in interest producing assets in a tax efficient manner. As with the new TEFs (see above), the government is seeking to move the point of taxation from the fund to the investor.

Interest will remain taxable at the level of the fund but will be available as a deduction from corporation tax when it is paid to shareholders as an 'interest distribution'. Any interest not so distributed in a period will not be available as a deduction from corporation tax and must be distributed as dividend income in the normal way.

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