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A legal update from Dechert's International and Domestic Tax Group

Investment Trusts – Tax Modernisation

HM Revenue & Customs, HM Treasury and the Department for Business Innovation & Skills recently issued a consultation document which proposes a significant modernisation of the tax treatment of investment trust companies ("ITCs"). If implemented, the changes may provide additional certainty and simplicity for ITCs and may, by removing many of the current impediments to obtaining investment trust status, encourage the incorporation of many more such vehicles in the UK.

ITCs are professionally managed, collective investment vehicles constituted as limited liability public companies, the shares of which are officially listed and traded on the London Stock Exchange. There are more than 200 ITCs in the UK with total invested assets of around £60 billion. They are exempt from corporation tax on chargeable gains, but otherwise taxed like any other company within the charge to corporation tax. To qualify as an ITC, a company must satisfy certain conditions and seek an annual retrospective approval from HM Revenue & Customs.

Currently it is common for investment companies that do not or may not meet these conditions to be established offshore, typically in the Channel Islands, where a no-tax regime can provide similar benefits.

The government's intention is to modernise the existing tax rules for ITCs by allowing for wider investment strategies, providing certainty on what transactions will be treated as investment for tax purposes and reducing administration. This could mean that new investment companies could more easily be established onshore rather than offshore and it may even encourage existing offshore funds to come onshore. Such companies could then utilise UK boards and UK service providers. Further details of the proposed changes are summarised in this article.

Eligible Companies

The proposed criteria for entry into the modernised ITC regime includes a new definition of a closed-end investment fund, similar to the definition in chapter 15 of the FSA listing rules. Although the proposed new definition would appear to extend the availability of ITC treatment, the consultation paper suggests that there will be exclusions from the new definition to ensure that only companies that would currently be recognised as investment trusts will be able to benefit from the new regime. The meaning of this proposal is unclear (and taken at face value would be inconsistent with the objectives of modernisation and allowing wider investment strategies) and interested parties should consider responding with comments.

Becoming an ITC

The existing tax rules require an ITC to seek retrospective approval from HM Revenue & Customs at the end of each accounting period. It is proposed that, under the new regime, eligible companies will be able to make a single, upfront application which will entitle the applicant to benefit from the regime on an ongoing basis. It is hoped this will ease the administration burden and provide greater certainty for ITCs and investors.

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Trading and Investment

ITCs are exempt from chargeable gains but taxable on trading income. Under the existing legislation there is a risk that certain transactions undertaken by an ITC could be considered trading transactions with the consequence that any profits on such transactions would be treated as income rather than capital and thus subject to corporation tax. In addition, if particular transactions do constitute trading transactions, they could taint other transactions of the ITC so that all of the ITC's transactions are treated as trading for tax purposes.

To give ITCs certainty that transactions will not constitute trading activity, the government proposes to introduce a 'white list' of transactions which ITCs can undertake with certainty that they will not be taxed as trading receipts. A similar model was adopted for Authorised Investment Funds in 2009. It is proposed that transactions in shares and stock, loan relationships, most derivatives, units in collective investment schemes, other "securities", foreign currency and certain other categories of investment will fall within the new 'white list'. The proposals also intend to ring-fence 'white list' transactions so they cannot be tainted by other trading transactions carried out by the ITC. However, transactions which are not on the 'white list' will not automatically be treated as trading transactions and the existing general tax principles will continue to apply (looking at the non-white listed transactions in isolation).

Spread of Risk

At present, restrictions limit the holdings that an ITC may have in another company to 15% by value of the ITC's investments. This limitation is intended to ensure a wide spread of risk. The consultation document proposes that the current 15% test be replaced with a "purposive approach" designed to allow greater flexibility whilst maintaining a spread of risk. This would be modelled on the approach adopted by the UK Listing Authority and essentially relies on the ITC publishing and following a defined investment policy detailing how it will meet the objective of spreading risk.

Close Company Condition

An investment trust cannot be a close company, but an important exclusion from what constitutes a close company is to be removed. At present, a company is not close if shares carrying at least 35% of the voting power in the company are held by "the public", are listed on a recognised stock exchange and have been subject to dealings on that exchange within the last 12 months. It is proposed to remove this exemption for investment trusts so any investment trust which is currently relying on this exclusion will need to consider its position.

Distribution of Income

Currently, ITCs are required to derive 70% of their income from shares and securities, and only 15% of such gross income can be retained. The consultation proposes to remove this income test to enable ITCs to invest in a broader range of assets. The flipside of this proposal is an intention to change the basis on which income (which, following the proposal above, will include total income from all investment types) may be retained. Two alternatives have been proposed. The first proposes that the percentage of total (gross) income which may be retained should be 10%. The second proposes that this requirement should be framed as a requirement to distribute 90% of total net income. Whilst the increased flexibility to invest in a wider range of investments may be advantageous for some ITCs, those which maintain their existing investment policy and continue to derive at least 70% of their income from shares and securities are likely (on either proposal) to see a significant reduction in their ability to retain income.

Investing in Reporting Funds

Currently, investment trusts investing in offshore 'reporting' funds account for their proportionate share of the reported income from such funds (to the extent it is not actually distributed) as capital, meaning it is exempt from tax. The government is considering provisions to treat such reported income as distributable income of the company, as is already the case for AIFs investing in such funds. Such a change could have significant implications for investment trusts investing in offshore funds, since the income reported but not distributed by offshore funds would become taxable in an ITC. In addition ITCs investing in such funds may (if the second distribution of income proposal above is adopted) be required to distribute income which is not actually received.

Related Companies Act Amendments

In overview, the Second EU Company Law Directive allows member states to apply special rules to investment companies for the payment of dividends. Broadly, the purpose of the special provisions is to enable investment companies to pay out as dividends all or most of what they receive as income on investments without reference to any change in the value of their investment assets. Under current law these special provisions are only available to UK companies whose business consists of investing mainly in securities and where those companies' shares are listed on a UK investment exchange. In light of the proposed changes to the taxation of investment trusts, the government proposes to change these rules so that companies which instead invest in various stocks and shares, land and other assets and whose shares are listed on a regulated market can also benefit from the special provisions.

Effects of Establishment Onshore

Establishing an investment trust in the UK rather than offshore would open up certain practical advantages. In particular, it would enable the company to have a majority UK board of directors and to facilitate the use of UK service providers, which may make the identification of suitable directors and the ongoing administration of the company a simpler process. A downside would be that transfers of shares in UK investment trusts remain subject to stamp duty/stamp duty reserve tax.

Summary

If the draft proposals are implemented widely, and the exceptions narrowly, the proposed changes could be very significant, reducing dramatically the need for choosing an offshore structure. With a wide scope, mixed funds (paralleling UCITS III) in the UK could become a real possibility. However, if the exceptions are as suggested in the consultation paper, so that only those currently qualifying would qualify under the new regime, it would be a significant disappointment and perhaps a wasted opportunity.

In addition, adopting the proposed change to the 'reporting funds' regime would mean that closed ended funds of hedge funds would have to remain offshore.

Within the consultation document, it is possible to discern two conflicting points of view—those within HM Revenue & Customs and HM Treasury who are concerned about the loss of tax revenue through the extension of the regime and those who see greater tax and stamp duty/stamp duty reserve tax revenues as a result of more taxable activities taking place in the UK.

History indicates that the volume of comments expressing a particular view can make a difference. Full details on how to comment on the consultation are set out in the consultation paper. The Association of Investment Companies will be making policy recommendations and is keen to receive feedback from its members on the consultation document, especially about the proposed reform of the retention test.

Practice group contacts

For more information, please contact one of the attorneys listed or the Dechert attorney with whom you regularly work. Visit us at www.dechert.com/tax.

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