

Anti-avoidance measures for Authorised Investment Funds

November 2010

Two anti-avoidance measures came into effect on 22 June 2010 (in Statutory Instrument 2010/1642) and have been introduced to ensure that a corporate investor cannot make use of an Authorised Investment Fund (AIF) to artificially create a tax advantage where no UK tax has actually been paid by the AIF. Two distinct amendments have been made which could affect distributions paid by AIFs.

First amendment: Limitation of corporation tax deduction

The first amendment impacts AIFs which satisfy the qualifying investments test (ie bond funds), but which have a mixed portfolio. The anti-avoidance measure limits the corporation tax deduction given for interest distributions to the extent that the distribution is derived from dividends which are exempt from corporation tax (franked investment income).

In practice the change should not have any impact on the tax position of an AIF paying an interest distribution, as franked investment income is not taxable when received by the AIF. However, there could be instances where this measure results in a higher tax charge at the fund level, for example where an AIF has taxable income in the capital account, which is not covered by the tax deductible element of the interest distribution. The following example shows how a tax liability would arise post 22 June 2010, but would not have before the change. It is also worth bearing in mind that there will be additional complexity when preparing corporation tax computations for AIFs in terms of 'streaming' income from qualifying investments and other income at the fund level.

This measure, however, imposes no streaming requirements on the recipient of such an interest distribution.

	<u>Income</u>		<u>Capital</u>
	£		£
Interest income	60	Offshore income gain	30
Dividends exempt from corporation tax	40		
	<u>100</u>		<u>30</u>

	<u>Tax computation pre 22 June</u>		<u>Tax computation post 22 June</u>
	£		£
Interest income	60	Interest income	60
Offshore income gain	30	Offshore income gain	30
Interest distribution	(100)	Tax deductible interest distribution	(60)
Net taxable income	<u>(10)</u>	Net taxable income	<u>30</u>

Second amendment: Foreign tax

The second amendment is aimed at preventing the conversion of foreign tax suffered by AIFs into deemed tax credits in the hands of corporate investors (including another AIF). It is aimed at AIFs which have taxable foreign income (ie foreign dividends which the fund has elected to tax or another source of taxable foreign income), where foreign tax has been credited in arriving at the AIF's UK tax liability. An AIF which has 'expensed' its foreign withholding tax, or a fund which is awash with excess management expenses should not be affected by this change in law.

Under the previous rules, foreign dividends which are exempt from UK tax are streamed into the 'franked' component of dividend distributions made to corporate investors. This contrasts with the position where such dividends remain in the 'unfranked' stream where an election has been made to tax foreign dividends, and where a tax credit would therefore be available to investors.

Where the AIF paying a dividend distribution has utilised double tax credit relief in calculating its UK tax liability, there would now be an additional third stream of income to corporate investors - unfranked foreign income with a deemed foreign tax credit. Any AIF receiving a dividend distribution from other AIFs will need to change the way they treat such dividends. In addition to those funds which may elect to tax in order to obtain treaty rates, certain other foreign income remains taxable post 1 July 2009, such as certain overseas Real Estate Investment Trust (REIT) income and income from overseas trusts, therefore the change may have a wider potential impact than originally thought.

The fund industry has expressed concern at the manner in which the second amendment was introduced, specifically without any prior consultation and the immediate effect of the changes. The Investment Management Association (IMA) has since received confirmation from HM Revenue & Customs (HMRC) with respect to the practicalities of the changes on corporate streaming rules post 22 June 2010. Although the changes included in SI 2010/1642 have no effect on the reporting requirements, it is anticipated that, in practice, corporate investors will expect the information provided on vouchers to reflect the impact of the amendments. To this extent, the IMA has agreed a possible template for a revised tax voucher with HMRC. The pro-forma tax voucher has been included in IMA's circular 323-10.

Conclusion

The anti-avoidance measures were introduced as a result of avoidance schemes of which HMRC became aware and were brought into immediate effect in the Emergency Budget in June 2010 in order to limit any scope for forestalling. They apply to any distributions paid after 1.45pm on 22 June 2010.

Although the vast majority of AIFs will not be impacted, it is important to consider the impact for those funds which could be, ie bond funds with mixed income and funds with taxable overseas dividends for which credit relief is claimed.

Contact us

If you would like to discuss any of the matters raised in this release further, please contact Anne Stopford or Dana Ward.



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