

Investment trust tax modernisation

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Over the summer, HM Revenue & Customs (HMRC) has published its eagerly awaited consultation for modernisation of the tax rules for investment trust companies (ITCs).

The existing rules providing for exemption from corporation tax on chargeable gains for ITCs as set out in sections 1158 to 1162 of Corporation Tax Act 2010 ('CTA 2010') (previously s842 ICTA 1988) have been in existence for 45 years and have changed little in that time. As more and more investment companies have chosen to establish themselves offshore, many in the industry have attributed this in part to the increasingly out of date UK tax regime, which does not cater for modern investment strategies and wider asset classes, creating unacceptable tax uncertainty, risk and cost.

Whilst it is clear that in the current economic climate there are to be no major tax concessions as part of this modernisation exercise, HMRC hopes that a more principles based regime with improved flexibility will help to remove some of the barriers to setting up ITCs in the UK. The new proposals have three main features:

- a new definition of a closed ended investment fund for tax purposes
- revised conditions to replace the existing criteria in sections 1158-1162 CTA 2010
- revised operational rules, covering matters such as application procedures, inadvertent breaches and distinguishing between trading and investment transactions.

Closed ended investment funds

The proposal is to define a closed ended fund for tax purposes in a way which is similar to that used in Chapter 15 of the listing rules - ie its sole object is to invest and manage shareholders' funds with a view to spreading risk.

The consultation indicates that there will be various exclusions in order to restrict entry to the regime to those entities which can currently attain investment trust status. However, there is no indication as yet as to what these exclusions will look like and HMRC is inviting comment on this area. For example, HMRC appears to intend that trading groups, VCTs and REITs would be excluded.

The proposed tax regime

Primary legislation will set out the definition of a closed ended investment fund as above and the detailed tax rules will be dealt with in regulations, which should make them easier to keep up to date.

The proposed eligibility conditions for joining the new regime are summarised below.

Close company condition

An ITC must not be a close company. Controversially, HMRC is however proposing to change the way in which the close company provisions apply to ITCs. At present, an ITC would not be a close company if 35% of the voting shares are held by the public and have been listed and dealt on a recognised stock exchange. It is proposed to remove this exemption. This could have a significant impact on some existing investment trusts, which may find themselves excluded from the new regime. A number of other ITCs could find they are required to carry out significant additional work to demonstrate that they are not close, for example where substantial shareholdings are held by nominee companies.

The spread of risk test

It is proposed to replace the existing 15% holding condition with a spread of risk condition to be modelled on the provisions in Chapter 15 of the listing rules, ie requiring ITCs to follow a published investment policy which sets out how risk spreading is to be achieved and deals with asset allocation, diversification, gearing and maximum exposures. Any material changes to the investment policy requiring shareholder approval under the listing rules would also need to be notified to HMRC.

This is a positive development as the 15% holding condition has over the years been one of the most problematic parts of the existing regime and there have been instances of ITCs inadvertently failing the test through accident, circumstance or the interconnection of holdings in some overseas markets.

The listing condition

Currently, ITCs must have their ordinary shares listed on the UK official list. It is intended to widen this to accommodate companies whose securities are traded on a regulated market. This could include, for example, companies admitted to trading on the Specialist Fund Market.

The distribution of capital profits prohibition

HMRC has indicated that this condition is to be rewritten to prevent an ITC from being able to distribute 'any' capital profits. This is different to the current condition which prohibits the distribution of investment gains by way of dividend, and care will need to be taken to ensure that the final regulations are written in such a way as to continue to accommodate share buybacks.

The distribution of income condition

The current requirement for ITCs to derive their income wholly or mainly from shares and securities is to be abolished. This is a welcome simplification.

HMRC's intention is to bring ITCs more in line with the conditions for Authorised Investment Funds (AIFs) and Real Estate Investment Trusts (REITs). AIFs are required to distribute 100% of profits and REITs are required to distribute 90% of profits attributable to the UK property business.

Therefore, HMRC is proposing to amend the retention condition, either by reducing the maximum permitted retention to 10% of 'total net income' or requiring an ITC to distribute 90% of its 'net revenue income'.

The consultation is not clear on the mechanism for the proposed alternatives, however the two alternatives do not appear to be equivalent. We understand that the first alternative is to be based, as is currently the case, on the tax measure of income but covering all income rather than income from shares and securities. The second would be based on net revenue income, which is not defined but which appears at first sight that it could be revenue profits after tax according to the accounts. Both proposals compare unfavourably with the current 15% retention condition, although HMRC have specifically requested views on the proposals and alternatives.

In particular, under the second proposal, many ITCs would be required to distribute significantly more than under the current condition as shown by the following example:

ABC ITC

Income from shares and securities	£90,000
Other income	<u>£10,000</u>
Total income	£100,000
Less expenses	<u>(£60,000)</u>
Revenue profit after tax	<u>£40,000</u>

	Distribution required	Retained profits
Current retention condition	£26,500	£13,500
Proposal 1: Retaining 10% of total net income	£30,000	£10,000
Proposal 2: Distributing 90% of net revenue income	£36,000	£4,000

The proposed changes are a positive move, however both proposals may reduce the ability of ITCs to manage their dividend flows to investors using accumulated revenue reserves.

Revised operational aspects

As well as the proposals to amend the conditions for ITC status, HMRC also proposes a number of operational changes. These include:

Upfront application

The existing process whereby ITCs apply for approval at the end of each accounting period is to be replaced. ITCs will make an upfront application to join the regime by submitting their prospectus /published investment policies and this will entitle them to the benefits of investment trust status on an ongoing basis, subject to compliance with certain breaching conditions.

Minor, inadvertent breaches which are remedied without delay would not cause a loss of investment trust status. This is a helpful proposal although HMRC appears to indicate that a trust breaching the same condition 3 times in a 10 year period (or 4 times for breaches of two or more conditions) would be expelled from the regime with no ability to re-apply at a later date. The lack of any proposed facility to apply to HMRC for consideration of the facts and circumstances in such a situation appears somewhat counterproductive and this may attract some comment.

A 'white list' of financial transactions

In order to give greater certainty as to the types of transactions that an ITC can enter into without running the risk that these will be deemed to be trading for tax purposes, a white list is proposed. This will be similar to the lists that apply for authorised funds and the Investment Managers' Exemption.

The list will include various specified derivative contracts and currency transactions, which is welcome given the demand for broader investment strategies in today's markets. As for authorised funds, it is suggested that if a transaction, which is not on the white list, is entered into and subsequently determined to be trading, this will be taxed as such but will not taint any other transactions entered into by the trust.

The introduction of the 'white list' for ITCs is very good news and it should mean that ITCs no longer have to set up subsidiary companies where they are concerned about the risk of trading.

Investing in offshore reporting funds

The consultation indicates that the government is considering provisions to require ITCs to treat income reported by offshore funds with reporting fund status as revenue of the ITC. This is an interesting conundrum as there is no basis in accounting standards for accounting on a look through basis, and the capital/revenue distinction for Statement of Recommended Practice purposes is substantively a legal matter. It will be interesting to see how this is resolved.

Companies Act 2006

The consultation also contains consequential changes to the rules for investment companies under the Companies Act 2006 (CA 2006). The proposed removal of the 15% holding condition and the revision of the listing condition in sections 832 - 835 CA 2006 align the proposed amendments to the tax legislation as outlined above.

There is however, a proposed change to the definition of the types of business, which an investment company can undertake broadening the activities to that of investing in land or other assets as well as various stocks and shares. This may allow more companies to elect to be treated as investment companies and so make distributions without reference to gains or losses on investments.

Conclusion

In general, the proposals are to be welcomed as they represent an improvement in the existing regime in a number of key respects. Upfront approval with an inadvertent breach regime offers greater tax certainty than the existing process of annual approval. The simplification of some of the investment trust conditions is also to be welcomed, as it will eliminate some of the pitfalls of the current system for gaining investment trust status. The proposed white list of transactions is also a significant step towards greater tax certainty, although some would argue that ITCs should have been included in this back in 2009 when the list was finalised for authorised funds.

The biggest concerns for the industry are likely to revolve around the proposed close company condition, the rules governing distribution of capital profits and the income retention restrictions. It will also be critical to consider carefully the proposed exclusions from the regime when the draft legislation becomes available for comment as these will be important in determining how the regime will apply in practice.

In the meantime, the consultation closes on 19 October with the Government seeking the views of the industry on a number of points, including the amendment to the close company condition and the distribution of income condition. Draft legislation and regulation will then be issued as part of the consultation stage, potentially as early as later this year.

Contact us

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