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INVESTMENT FUNDS GROUP

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UK Budget Changes: Impact on Funds

The UK Chancellor's Budget Touches On Some Issues Concerning Investment Management and Funds

INVESTMENT MANAGER EXEMPTION

The budget announced an extension to the investment manager exemption to include carbon credit trading within the scope of the exemption. The investment manager exemption allows non-UK funds and structured finance SPVs to appoint UK investment or portfolio managers without becoming subject to UK tax (provided the relevant conditions are met). At present, carbon credit trading does not qualify for the investment manager exemption, although cash settled derivatives relating to carbon credits do. The investment manager exemption, anticipated to take effect around the middle of April, will be extended to cover carbon credit trading. Trading in other commodities will remain outside the scope of the investment management exemption.

PROPERTY AUTHORISED INVESTMENT FUNDS

While the regime for real estate investment trusts (UK-REITs) came into effect on 1 January 2007, no similar regime has yet been established for authorised investment funds (AIFs) investing in real property or UK-REIT shares. The design of such a regime presents the same challenges as for UK-REITs, but the nature of AIFs as open-ended entities provides additional complexities.

Following consultation with the Investment Management Association and other industry and representative bodies, a framework has been devised. This will move the point of taxation from the Property AIF to the investor and will permit broadly the same tax treatment as if the investor owned real property or UK-REITs shares directly. The main elements of the proposed framework are:

- AIFs which are predominantly invested in real property or UK-REITS may elect to join the regime,
- Property AIFs must operate three pools of income - property income, other taxable income and UK dividend income. The AIF's expenses will be allocated between these pools. This will enable the AIF to value, in accordance with FSA regulations, its net assets each day, taking proper account of tax (the "daily-pricing" requirement),
- Investors will receive distributions of each type of income and be taxed accordingly,
- Because of the different way in which unit trusts and open-ended investment companies are treated under the UK's double tax treaties, only open-ended investment companies will be permitted to become Property AIFs,
- No "entry charge" into the regime will be required, as AIFs are exempt from tax on capital gains, and

- Rules are to be developed to replicate the restrictions on UK-REITS concerning ownership of more than 10 percent of the Property AIF by a company or ownership by a small number of investors.

Work will continue on developing this regime.

OFFSHORE FUNDS

Gains on "material interests" in offshore funds are charged to income tax, not capital gains tax, unless the fund obtains certification from HM Revenue & Customs that it is a "distributing fund". One requirement for certification is that the fund must not invest more than 5 percent of its assets in other offshore funds, unless such investee funds could themselves obtain distributing fund status. In determining whether an investee fund meets the requirements for certification, it is not permitted to ignore any such offshore funds in which the investee fund is invested. Consequently, it is difficult for a multi-tier fund of funds to meet the distributing fund test. This restriction is to be removed so that, for the purposes of the 5 percent investment restriction in other offshore funds, it will be possible to ignore at all levels of a fund of fund structure investments in an offshore fund that can obtain distributing fund status itself.

An offshore company is within the offshore funds regime only if it is a "collective investment scheme" as defined by the Financial Services and Markets Act 2000. This requires the company to be an "open-ended investment company", as defined by that Act. The Financial Services Authority considers that a company that requires at least six months notice to be given by an investor wishing to redeem his interest in the company cannot be open-ended. This has led to the establishment of a number of funds that are thereby regarded as "closed-ended" and therefore outside the offshore funds tax regime, but which effectively operate as open-ended companies. For the purposes of the offshore funds regime, a company will now be treated as open-ended, and so within the regime, if the investor can reasonably expect to realise the net asset value of his holding within seven years of acquisition of the holding. This seems to bring within the income tax regime not only companies that will redeem their shares on investors' request and are regarded for regulatory purposes as "closed-ended", but also genuine closed-ended companies that state an intention to wind-up within seven years of launch. It is not clear whether this will affect existing shareholders.

Legislation will confirm that a loss on disposal of an interest in a non-distributing offshore fund is indeed a capital loss and cannot be set against income. This provision will counter a potential argument that such a loss could instead be relieved against certain types of income.

As previously announced, the way investment trusts' holdings in offshore funds are treated is to change. Gains on such holdings will not be taken into account in determining whether the investment trust meets the requirement that its income must be derived wholly or mainly from shares or securities, but will continue to be taxed as income.

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