

Investment trust companies: a tax framework

Submission by The Association of Investment Companies

The Association of Investment Companies (AIC) welcomes HM Treasury's proposals to reform the tax rules for Investment Trust Companies (ITCs) to allow them to invest in a wider range of assets. It is strongly supportive of the proposed changes and **recommends** that they should be brought forward in the 2009 Finance Bill.

Overview

ITCs are closed-ended companies whose shares are listed in the UK. They invest in a diverse portfolio of assets to provide their shareholders with an investment return – either as a capital gain when the investor sells their shares at a higher price than when they bought them, or as income when they receive dividend payments. There are currently some 214 ITCs, with assets under management of just over £60 billion.

Traditionally ITCs were the only type of UK listed investment company but market developments mean that this is no longer the case. The last ten years or so have seen the offshore investment company sector grow significantly, despite being virtually non-existent before then. These offshore companies operate in much the same way as ITCs but are subject to more liberal tax rules which enable them to invest in a wider range of assets without adverse tax consequences.

In particular, they are able to receive interest from bonds and other similar securities without the deduction of tax within the company. This allows them to offer a more diverse range of tax-efficient investment propositions to investors. The AIC estimates that the offshore investment company industry¹ has assets under management of around £30 billion.

The growth of offshore alternatives to ITCs is a compelling illustration of the need for the UK authorities to modernise the tax and regulatory regime to allow ITCs to provide equivalent benefits to their shareholders. Implementing the proposed reform will be an important step which will create a more attractive environment for ITCs. This change should be a priority for HM Treasury as it will deliver significant consumer benefits. It will give existing ITCs the potential to earn enhanced investment returns and increase consumer choice. It will also facilitate the development of new ITCs with a remit to invest in interest bearing securities from their launch. Evolution of the ITC market will support the overall development and international competitiveness of the UK's financial services sector, an important source of employment and tax revenues.

¹ This estimate includes only those offshore companies who trade in the UK (on the London Stock Exchange or AIM). If other markets were included the industry would be significantly more substantial.

Objectives of reform

The consultation document sets out four objectives:

- allowing ITCs to invest tax-efficiently in bonds and other interest producing assets;
- ensuring that UK investors continue to choose their investments for commercial rather than tax reasons;
- preventing unintended tax advantages being gained through investing in an ITC rather than direct investment;
- implementing the change at no overall cost to the Exchequer.

We are confident that the proposals, as set out in the consultation paper, should allow these objectives to be secured. We hope to work closely with HM Treasury as the relevant legislation is developed to ensure that they are successfully delivered.

Creating an optional regime

The intention to create an opt-in regime is strongly supported by the AIC.

This approach will mean that existing ITCs which choose not to take advantage of the regime will not face any additional costs. That said, we envisage that, over time, quite a significant number of ITCs will choose to adopt streaming and adapt their investment approaches to exploit new investment opportunities as they seek to deliver returns for shareholders.

Where existing ITCs do decide to go down the streaming route their assessment will be that the benefits of entering the regime outweigh the costs. This approach almost guarantees a positive cost-benefit analysis.

Of course, the above conclusion does not remove the need to ensure that any rules which are introduced are proportionate, with the lowest compliance burden possible, as this will enhance the attractions of the regime and reduce costs (which are ultimately borne by shareholders).

Securing an opt-in basis for the streaming regime has been a key priority of the AIC in its discussions with HM Treasury over possible reform. We are delighted that this approach is to be adopted.

However, we note the consultation paper's initial suggestion that an ITC adopting streaming would inform HMRC of its intention to stream as part of the approval process for each accounting period. This precise approach may be inappropriate for a number of reasons – not least because investment trust approval is granted on a retrospective basis and a notification for streaming would apply to the coming period.

Our early view is that any ITC entering the regime would do so at the start of their accounting period. The ITC would then make distributions during the period according to the requirements of the streaming rules. (The rules might even require this as a condition for approval at the end of the year.) At the end of the period, when it makes its retrospective application for 842 status for that year, it would also provide details of how it has complied with the streaming requirements. However, this would not be a 'notification' for the coming period.

The details of 'notification' is not a major issue, but getting the mechanics of administering the regime right to minimise the compliance burden implied by the regime is worth considering carefully as the proposals are developed.

Interest investment income

The AIC agrees that the best way to deliver streaming will be to continue to tax interest income within the ITC and to make the distribution of income deductible expenditure within the ITC's corporation tax computation once it is paid to shareholders as an 'income distribution'. We envisage that this approach will reduce the potential for possible complications in relation to tax treaties.

We also agree that the interest distribution should be treated as a payment of yearly interest and that income tax at the lower rate should be deducted (and accounted for) by the ITC, except where the shareholder is entitled to receive gross payment of interest. Shareholders will then be subject to tax on interest income at their normal rates. This will ensure that the Government's objectives vis-à-vis tax receipts and proper incentives for investment etc are delivered. Of course, it will be important that suitable mechanisms are developed to enable the ITC to know the tax position of the shareholder – or non-taxpaying beneficial owner where the shares are held through nominee arrangements. However, we envisage that arrangements of this nature have been developed in other areas and would anticipate that it will not be prohibitively complicated to extend these arrangements to 'streamed' ITCs.

We note the proposal that undistributed income should be subject to corporation tax to prevent unintended tax advantages being gained through investing in an ITC and that undistributed income which is carried forward and distributed in a future period should be treated as a dividend distribution.

We are sympathetic to this approach but would be keen to explore the possibility of creating a more flexible regime to maximise the commercial attractions of streaming. For example, it would be commercially attractive if an ITC were able to retain some portion of its interest income (perhaps 15%) to allow it to build up a reserve which could be distributed as an interest distribution in a future period – perhaps with a requirement that it be distributed in the next three years. This does have implications for the impact of the policy and we are aware that HMRC would want to carefully control any carry forward of this nature, but if it could be achieved without complexity or risk to the Exchequer it would be a very attractive option to consider.

The AIC is strongly supportive of the decision to give ITCs who enter the streaming regime discretion over how much they invest in interest bearing securities. This will allow a wide variety of investment approaches to be adopted and mean that existing ITCs will be able to use the regime as it suits them. It also offers the potential for new types of ITC to be launched, including those dedicated exclusively to bonds, as well as balanced funds. It could even allow innovations such as 'lifestyled' funds (where the exposure to equities and bonds is rebalanced over time to shift the emphasis of the portfolio from capital growth – via equity exposure – to capital protection and income – as bond exposure is increased).

Which approaches will ultimately be adopted are a matter for the market. The critical issue in this process is that the tax rules should allow as much flexibility as possible as long as the headline policy intentions of the reform are secured.

Other investment income

The AIC's overwhelming priority has been to secure the opportunity to invest in bonds and other interest producing assets – which this proposal will allow.

One matter of detail raised by a number of our members is that the definition of interest producing assets should be drawn as widely as possible (in particular, the inclusion of 'cash' accounts has been mentioned a number of times in the feedback we have received on these proposals). The AIC sees no reason why a broad definition should not be adopted, as this will maximise the opportunities for ITCs to invest in a wide range of products, diversify their investment risk and secure attractive returns for shareholders, while still being within the overall policy intent of the proposed change. Notwithstanding this approach, it will also be important to constructing the regime so that it is compatible with the 'shares and securities' test, which may itself need reform to make streaming workable.

While in an ideal world other income (such as rent) could also be streamed, we recognise that there are substantial complications in securing this outcome while still achieving the HM Treasury's identified objectives. Overcoming these issues would create unnecessary delays and complexity.

We therefore support the decision to introduce a regime which will continue to subject to corporation tax any other income received by an ITC which has opted to 'stream'.

There may still be some investment by ITCs in, for example, property as they may have expenses that they can offset against their tax charge. If they do not have sufficient expenses to offset their tax charge they may end up paying tax. Whether or not they decide to invest in assets producing taxable income would be a commercial issue for the ITC to consider and should create no policy concerns for HM Treasury as it provides a potential income stream for the Exchequer.

Transitional arrangements

Whether or not transitional arrangements are required is likely to depend upon the precise details of the regime. However, the AIC anticipates that transitional arrangements should not be required if the practical requirements of the regime are appropriate (see discussion above). We will be pleased to discuss this matter in detail with HM Treasury as the rules are developed.

Conclusion

The AIC is keen to work with HM Treasury to ensure that these proposals are introduced at the earliest possible juncture and in the most commercially attractive way. We would be pleased to provide any technical assistance required to help finalise the required legislation.

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To discuss the issues raised by this paper please contact:

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