

Tax Elected Funds: A Discussion Paper.

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to respond to the discussion paper published by HM Treasury (HMT), on 28 July 2008, in relation to the proposed Tax Elected Funds (TEFs) regime. The main aim of the proposals is to consider an approach where funds will not pay tax on certain investment income at the fund level for Authorised Investment Funds (AIFs) based in the UK, with the aim of making the UK a more competitive location for asset management.

The discussion paper has an impact on a number of Grant Thornton's clients, in particular investment managers and the UK authorised funds they manage. Grant Thornton's Financial Services group includes specialists dealing with investment managers and Authorised Unit Trusts (AUTs) and Open-Ended Investment Companies (OEICs).

Our view

In general, we welcome the discussion paper which forms part of a package of proposals which attempts to enhance the competitiveness of the UK as a place for funds to locate. We specifically welcome the proposals where UK AIFs which elect to become a TEF will not pay tax on certain investment income. The key aim of the proposals is to leave the investors in broadly the same tax position as if they had invested directly in the underlying investments of the funds. The proposed TEF would be perceived to be more tax efficient for many tax-exempt UK investors (ie pension funds, charities, and Individual Savings Accounts) and overseas investors and help level the playing field between UK onshore open-ended funds and other offshore funds located notably in Ireland and Luxembourg.

We also welcome a regime that is elective thereby allowing funds to elect into the new regime following a positive cost/benefit analysis, or to remain under the current tax regime, whichever is in the best interests of their investors.

Clearly as a result of funds not paying tax on certain investment income at the fund level there may be some minor loss of income to the Exchequer. However many AIFs have had excess management expenses available for a number of years and do not have taxable income as a result. Those that do have taxable income are often in a position to credit foreign taxes such that a minimal UK tax charge arises.

It is imperative to recognise the considerable operational complexities and costs that imposing streaming of TEF income would lead to and the impact of these costs on the 'take-up' of the new regime. In practice, the implementation of a system which is required to stream the income flow (which is not dissimilar to Property AIF (PAIF) regime) may present difficulties in terms of upfront implementation costs involved in updating and replacing systems throughout the intermediation chain and ongoing operating and compliance costs from operating within the TEF regime. In addition, costs incurred in familiarisation with the new rules and disclosures to investors may present a barrier on the take-up of this new regime, particularly at a time of difficult market conditions. Furthermore, streaming may only offer minimal preservation of tax revenues where an AIF is largely invested in by UK taxpayers and it may well be the case that streaming may only be feasible from a practical and economic perspective where a single administrator services multiple AIFs, where the benefits may exceed the total costs of opting into the new tax regime if streaming is required.

Whether or not an AIF decides to opt into the new regime would be a commercial issue for the AIF to consider and should create no policy concerns for the Government.

We set out below a summary of our comments on the main issues that we consider are of key importance:

Elective regime (3.3)

We welcome the elective nature of the new regime which allows funds to elect or remain under the current tax regime depending on their investor profile and overall investment strategies. We are of the opinion that, although the new proposed TEF regime may not be suitable for AIFs with purely or mainly taxable UK investors, depending on the final details of the regime, it may remain attractive to AIFs with a large number of tax-exempt and overseas investors.

We appreciate the rationale for the proposed irrevocable nature of the election made by the fund to be a TEF to provide greater certainty to the funds, their investors and the Exchequer. However in the event of a TEF altering its investment strategy significantly or overseas tax authorities denying treaty benefits it may be beneficial to consider allowing a TEF to apply to opt out of the regime in exceptional circumstances where investors would be disadvantaged by the fund remaining as a TEF.

Double taxation treaties (3.4 & 3.5)

The ability of AIFs to access double taxation treaties is important for many AIFs in particular for those funds investing in overseas equities. Although under the current proposals income from foreign dividends will not be taxable in a TEF, access of the funds to the lower treaty rates may be lost. This could result in an increase of tax at the fund level compared with the case where a fund has not elected into the TEF regime. On the basis that TEF will not be treated as transparent for UK tax purposes (therefore no credit will be available for the investors for any overseas tax paid), it may prove to be less attractive for a fund to be elected into the proposed regime.

We suggest that the Government conducts further research into the impact of the proposals on the access to treaty benefits with the aim of providing greater certainty to AIFs on the effect of electing to be a TEF on their access to double taxation treaties. One possible solution would be to treat the TEF as transparent for UK income tax purposes thereby allowing the investors to claim the credit for any overseas tax paid.

Genuine diversity of ownership (3.6)

We understand the concern of the Government in introducing a genuine diversity of ownership condition to protect the UK tax base by preventing TEFs being used to obtain unintended tax advantages. We note the current ongoing consultation between the Government and the industry on draft regulations replacing the 10% substantial holding test for Qualified Investor Schemes (QIS) with a diversity of ownership condition.

We believe, depending on the final details of the proposed regime, the purposive genuine diversity of ownership condition should not hinder the take-up of the proposed regime. For funds which comply with the QIS diversity of ownership condition, they should be treated as satisfying this condition if they elect into the TEF regime, or vice versa.

Tax treatment of income, gains and distributions (3.7 to 3.10)

We understand the rationale behind the proposed income streaming as certain types of income are taxed differently in the hands of either institutional or individual investors and the need to ensure sound and sustainable public finances. As above, we are concerned with the additional costs associated with the income streaming (similar to the income streaming rules for the PAIF regime where three streams of income are identified) and the operating complexities on disclosing this information to the investors. We question whether the level of benefit of tax revenues preserved by streaming will warrant the cost and complexity associated with streaming which may ultimately have the effect of severely limiting participation in a TEF regime.

We are keen to see only the payment of one amount at each distribution point thereby reducing costs in updating the current systems throughout the intermediation chain and the complexities which arise as a result of multiple disclosures to investors. We believe the key point here is the investors should receive an equivalent amount of net return after expenses either investing in UK or offshore funds.

Foreign investment income (3.12 to 3.17)

We note that the Government is currently consulting with the industry on the taxation of foreign profits and treatment of foreign dividends in the hands of UK individual investors. While we welcome the proposals to abolish corporation tax on foreign investment income for an AIF elected to be a TEF, clearly the outcome of these consultations will impact upon the final details of the proposed regime for the treatment of distributions to investors in an AIF that decides to opt into the TEF regime.

Property investment income (3.18 to 3.20)

Under the current proposals, a TEF will not be permitted to invest in property. We understand the reasons behind this as a PAIF regime was introduced in April 2008 to allow investors to invest tax efficiently in property via open-ended funds. However, in view of the potential of a TEF to earn enhanced investment returns and the need to offer a more diverse range of investment propositions to investors, we suggest that a small percentage of income from a TEF could be derived from property income.

In addition, we are of the view that investments in foreign property should be permitted to level the playing field in terms of the investment portfolio and overall investment strategies of UK funds and offshore funds.

Other income (3.21)

We welcome the proposals that TEFs will not be taxed on interest and other investment income not included above. We agree with the suggested approach by the Government that other investment income should be distributed to investors as if it was an interest distribution and thereby subject to tax in the hands of the investors accordingly with the aim of balancing fairness for investors with simplicity.

Offshore income gains (3.22 & 3.23)

Similar to foreign investment income, we note the current reform of the Offshore Funds Regime and the proposals of introducing a reporting fund regime. Clearly the outcome of the consultations on Offshore Funds will impact upon the final details of the proposal regime for the treatment of offshore income gains in the hands of corporate and individual investors.

Expenses (3.24)

We are of the opinion that special rules should be introduced with regard to the allocation of operating costs within a TEF.

Existing tax regimes (3.25)

At it stands, funds that are currently within the bond fund regime should not suffer any tax at the fund level on the basis that all income after expenses is distributed to the investors. As a result, a bond fund would be in no better a tax position if it elects to be a TEF, on the contrary it would incur significant operating costs in changing and updating the systems with no benefit for its investors. We do not envisage any take-up of the new regime for funds that are currently within the bond fund regime and would support the retention of the current bond fund regime.

Breaching conditions (3.26 & 3.27)

We fully support the current proposals where a TEF will not suffer adverse UK tax consequences on minor and inadvertent breach where the breach is remedied without undue delay. The concession should provide greater certainty for funds electing to become a TEF and its investors.

We understand the rationale that a TEF would lose its status in the case of repeated non-compliance or deliberate breaches.

Transitional provisions (3.28)

We support the plans to include transitional provisions for AIFs wishing to elect to be a TEF. We look forward to providing further comments on transitional provisions as the TEF regime is developed.

Conclusion

We welcome the Government's proposals in relation to AIFs. We would be very happy to assist in providing further information or explanations on matters contained in this response and we look forward to taking part in any further discussions that may arise.

Questions concerning these comments on the consultation paper can be addressed to:

Anne Stopford (email: anne.stopford@gtuk.com)

Dana Ward (email: dana.ward@gtuk.com)

Aii Ling Young (email: aiiling.young@gtuk.com)

Grant Thornton UK LLP
Grant Thornton
Melton Street
Euston Square
LONDON
NW1 2EP
Telephone: 020 7383 5100
Fax: 020 7383 4715



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