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PART A

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PART. A

1989 BUDGET
UNIT TRUSTS.

THIS FOLDER HAS BEEN
REGISTERED ON THE
REGISTRY SYSTEM

Unit Trusts

11 ~~484~~

UNIT TRUSTS

JOHNS - IR
→ FST 9/12

CONFIDENTIAL

I am v. attracted to X, which has much to commend it. What wd be the cost of a variant in wh. the CT rate was 35% instead of 40%? 2. On the main Budget, looks attractive with Life Assce co's CT & CGT rates reduced to 25%. NL.

Inland Revenue

Oil and Financial Division
Somerset House

FROM M A JOHNS

DATE 9 DECEMBER 1988

1. MR BEIGHTON See below
2. FINANCIAL SECRETARY

UNIT TRUSTS - BUDGET STARTER 156

1. I attach two notes on the taxation of unit trusts by Mr Nield covering two competitive problems for UK unit trusts compared with their European competitors:

a. A unitholder in a UK unit trust will incur a capital gains tax charge if he switches to another fund; it is possible to set up offshore "umbrella" funds where there is no charge on switching.

b. If a UK unit trust invests in fixed interest stocks or foreign equities it suffers a corporation tax charge on the income for which the investor does not get full credit; most European equivalents are broadly transparent and do not incur such a charge.

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cc Chancellor
Chief Secretary
Economic Secretary
Paymaster General
Sir Peter Middleton
Mr Scholar
Mr Culpin
Mrs Lomax
Mr Ilett
Mr Neilson
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Jenkins (Parliamentary Counsel)
Mr Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Houghton
Mr McGivern
Mr Corlett
Mr Deacon
Mr Pitts
Mr Johns
Mr Bush
Mr Nield
Mr Fitzpatrick
Mr Reed
Mr M Haigh
Mr P Fawcett
Mr Cayley
Mr Kuczys
Mr J F Hall
Mr Bolton
PS/IR

There is a clear read across to Mr. Deacon's note of 8 December on life assurance acquisition expenses. Further work in the last day or so suggests that the differentials in reducing the CT rate on unit trusts to 25%, while they remain, are not perhaps quite as great as I suggested in my own minute of that date.

HB 9/12

UMBRELLA FUNDS

2. Offshore umbrella funds are already advertising their CGT advantages widely and UK unit trust groups are setting up offshore affiliates to get the same benefits. We are a little sceptical of how many investors actually benefit from the switching option. Nevertheless, there could be a risk of more business moving offshore if the playing field is not levelled. Removing the charge on switching funds in the UK would substantially erode the CGT take on securities. We suggest a level playing field should be created by imposing a charge on UK investors when they switch within offshore funds. This would leave a problem over offshore life policies where switching is also possible without tax. In view of other possible changes in life assurance taxation we do not think legislation on switching would be possible this year but it would be desirable for Ministers to say they will review this area or the competition for the UK unit trust movement will just transfer to life assurance. (There is also a potential problem over offshore non-unit trusts but these are being looked at in the current review of trusts.)

TRANSPARENCY

3. UK unit trusts are taxed on income like companies. This means they get relief for the expenses of managing the portfolio which an individual investing direct does not get (and they get relief for interest on borrowings to finance investments). On the other hand, while no corporation tax charge is imposed on franked investment income from UK dividends, on other income the trusts pay tax of 35% only 25% of which is credited against personal income tax. And the unrelieved tax can be even more on foreign income where the foreign withholding tax cannot be credited against ACT on the distribution to the unitholder.

4. True transparency would remove the CT penalty but also remove the relief for management expenses and the potential

relief for interest. This is already effectively an option for gilts unit trusts and could relatively easily be extended further. However, this is not what the UTA want. They want to have the benefits of relief for management expenses but not the penalty of a CT charge on unfranked investment income.

5. The reason for this is that this is what other European countries do. Mr Nield examines how great a competitive edge this gives them. There can be little doubt that, although there will be many other factors, a UK fund investing in anything other than UK equities will be at a significant tax disadvantage compared with foreign competitors. This is likely to be more of a problem holding up the growth of UK funds in other European countries than one leading to the spread of offshore funds in the UK. Any loss of competitive position is likely to be gradual. And in view of marketing obstacles to expansion in Europe, the business at stake may not be large. But it would be unfortunate if the UK tax regime were to prevent a successful UK industry from exploiting the common European market to the full.

6. There are four main problems about removing the competitive disadvantage.

Comparison with direct investment

7. Putting UK unit trusts on a level playing field with foreign equivalents means putting them ahead of direct investment by UK taxpayers and so running counter to your general policy of reducing the tax encouragement to institutional investment wherever possible. We suggest that allowing relief for management expenses (already effectively available without penalty for trusts investing in UK equities) should be conceded but that you should not concede relief for interest. This should not be much of a penalty compared with European competition since the UCITS directive only permits borrowing up to 10% of the value of the portfolio. But it would protect the principle that tax relief is not available in the UK on individuals' borrowing to finance investments.

Deduction of tax at source from distributions to unitholders

8. Luxembourg does not deduct any tax from distributions to investors although any tax deducted from income before it is received by the investment company is passed on. Other European countries, however, deduct a withholding tax on dividends but this can then be credited against the investor's personal tax liability. The UTA want a system which is competitive with Luxembourg under which distributions to non-UK residents are paid gross. They accept that this is not possible for distributions to UK unitholders, and that basic rate tax must be deducted in this case (as for annual payments). This is because the UK system depends on most income having basic rate tax deducted at source so that most basic rate taxpayers do not need any end of year assessment. What they propose is gross payment to unitholders who certify they are non-resident (as with composite rate).

9. There are several problems with this. First, there would be problems of enforcement (especially where a non-resident returns to the UK). Secondly, there is a risk that the US and other countries would deny unit trusts the benefits of the US/UK Treaty withholding tax rates - Luxembourg vehicles face a 30% rate compared with 15% for UK trusts at present. Thirdly, the UK would be collecting less tax from European investors than its tax treaties with their countries provide for, treaties which were negotiated to provide a balance of advantage for both parties. And finally it would appear a provocative gesture to France and the European Commission to remove a withholding tax we already impose when they are trying to negotiate a minimum withholding tax to combat Luxembourg competition. If this is not conceded to the UTA they will be at some competitive disadvantage with Luxembourg but not with most other European countries. For the honest investor it is only a matter of delay and the hassle of claiming tax credit; for the dishonest it is a permanent loss. But our view is that the competitive benefits are outweighed by the disadvantages of this change.

Conversion of one type of income into another

10. If tax is to be deducted at source from distributions to UK unitholders there will need to be a mechanism for crediting tax deducted at source from investment income received by the trust against this tax. The present corporation tax system achieves this but a new system would have to be devised under the UTA's scheme. A particular problem arises where companies invest in unit trusts: franked investment received by the trust would get converted into unfranked income which may be less attractive to the corporate investor. We are proposing an alternative scheme which preserves the CT regime but achieves a similar effect to exemption by setting the CT rate at 25%. This would have the reverse effect that unfranked investment income would be converted into franked income which would mean that corporate unitholders would be undertaxed on it. Another problem arises with income which has had foreign tax deducted: if we convert this into UK tax then we could find ourselves repaying foreign tax to exempt investors. The UTA toyed with ideas which would involve each stream of income retaining its original characteristics when passed on but now accept this is too complex to operate.

11. At present we see no easy solution in either case. For foreign tax the situation would be no worse than under the present scheme. For corporate investors we think we would have to find a route to charge mainstream CT on distributions from the trust to prevent avoidance but this would leave the position on franked investment income worse than under the present scheme. The UTA therefore propose that trusts should have an option on whether to stick with the present regime or adopt the new one. Options add complexities and risks of dodging from one scheme to another and we would much prefer to avoid them. The main corporate investors in unit trusts are life companies. If you decide to reduce their corporation tax rate to 25% (see Mr Deacon's note of 8 December) they would have no problem and we would then feel that other companies investing in unit trusts do

insert the complexities

of options. Tax privileges for unit trusts are designed for individual investors not corporate ones.

Coverage of the scheme

12. The other difficult question is to decide which UK investment media should qualify for transparent treatment. The UCITS directive only covers open ended securities funds which are widely marketed. The present regime for authorised unit trusts is broadly the same as that for investment trusts and either can now or shortly will be able to cover property funds, money funds, financial futures and options funds and possibly commodity funds. All these types of funds are pressing for transparency but there are additional problems besides those described above (should a property trust be able to get tax relief on interest since an individual investor in property can? Should a money fund deduct composite rate tax rather than basic rate tax? Should a financial futures and options fund effectively escape all tax through the CGT exemption?) Investment trusts are not currently pressing for transparency but could be expected to do so if their unit trust competitors get it. On the other hand, they are much more heavily geared so the tax treatment of interest will be very important for them. And they merge almost imperceptibly into the generality of investment companies.

13. We suggest that any changes this year should be restricted to trusts covered by the UCITS directive as that is where the immediate competitive threat lies. You could promise to do more work next year to consider extending the boundaries at a later stage. This will not necessarily be easy and there is a risk of raising expectations which cannot be fulfilled and of ending up with a fairly uneven playing field within the UK.

Read-across to life assurance

14. You will also obviously be concerned about the read-across to life assurance. Life assurance companies may make three

connections; there are good answers to each of them but they may not be politically easy.

a) Why are you acting now on European competition for unit trusts but waving aside the European dimension on life assurance? - Because the UCITS directive comes into force in 1989 whereas harmonised regulation of life assurance is likely to come only over a number of years stretching well into the mid-1990's.

b) Why are you moving towards transparency for unit trusts but not making comparable moves for life assurance? - The life assurance consultation document offered the route of looking through to the investor (Option A) and the life assurance industry themselves reject that as impracticable. We should, however, be prepared to look again at Option A for investment linked policies if the companies so wish.

c) Why are you relaxing the rules for expenses for unit trusts and tightening them up for life assurance? - We are talking about two different types of expenses. Administration expenses are allowable in full for life assurance and it is not proposed to change this: initial selling expenses will not be relievable against the investors' income from unit trusts even after the change. (The precise terms of this answer may, of course, depend on the final decision on life companies' expenses - see Mr Deacon's minute of 8 December.)

<u>Read-across to close investment companies</u>

15. Other budget starters which could be relevant are the proposals to scrap close company apportionment and substitute a 40% corporation tax rate for close investment companies. It would be necessary to argue that it was not inconsistent to increase the effective rate of tax on close investment companies and reduce it for unit trusts. The argument would be that unit

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trusts have to distribute all their income whereas higher rate individuals could roll up investment income within a close company.

CONCLUSION

16. In short we think the unit trust movement does face a competitive problem in Europe. Some problems are inevitable because evasion is easier through foreign vehicles and this is why the French and the European Commission are proposing harmonisation of information powers and withholding taxes. What the UTA want is to be put on all fours with Luxembourg but this would put them significantly ahead of direct investment and create problems with other partners. Worthwhile improvements can be achieved, short of this, to put them on a part with other European collective investment vehicles.

17. Action on offshore umbrella funds would remove one problem but offshore life assurance would need to be reviewed to provide complete protection. On the other problem, we recommend, as an alternative to the UTA's scheme, reducing the CT rate on unit trusts (Option 3) to 25%. This achieves their main objective of removing a charge on the trust which cannot be credited against the individual investor's personal tax liability. Even this, however, creates problems for the corporate investor. If life assurance companies' rate of tax is also reduced to 25% (see Mr Deacon's note of 8 December) we think these are manageable. Otherwise we see serious administrative complexities either in an option or in complex documentation of how distributions are derived from franked and unfranked income. More work is needed on how to minimise these. The cost of our proposals would be around £20m a year.

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18. We suggest the new regime should initially be limited to open ended securities funds, and this would raise complaints of unlevelling the playing field within the UK. You could promise to review extension (at additional cost) but there could be no guarantee that this would be easy.

M.A. Johns

M A JOHNS

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→ FST
9/12

CONFIDENTIAL

Inland Revenue
OIL AND FINANCIAL DIVISION

Somerset House

FROM: A G NIELD

EXT: 6412

DATE: 9 DECEMBER 1988

FINANCIAL SECRETARY

UNIT TRUSTS: UMBRELLA FUNDS

INTRODUCTION

1. This note reports on the Unit Trust Association's concerns on the need to achieve a level playing field as between UK unit trusts and offshore "umbrella funds". Umbrella funds are already marketed in the UK. The UTA argue that their members will have to go offshore if they wish to compete on even terms with these funds.

NATURE OF UMBRELLA FUNDS

2. An "Umbrella fund" is an offshore investment fund, generally in the form of an open-ended investment company. Open-ended means that the company can increase or decrease its share capital at will. The investments managed by the fund are divided into different pools (or sub-funds), each specialising in a particular type or area of investment. For example, the fund might have an income pool, a growth pool, a US securities pool, a Japanese pool, and so on.

3. Shares in the fund are divided into classes. The value of and return on each class is tied to a particular investment pool. For example, class A shares might represent investment in an income pool, class B in a growth pool, class C in a US pool, etc. The shares give the investor the right to exchange shares of one class for another. So the investor can effectively switch his investment between types of fund, without disposing of his interest in the company.

4. UK Company law does not allow open-ended investment companies to be established in the UK. It is possible for onshore unit trusts to have different classes of unit within the trust, and for investors to be able to switch from one class to another. But because of the different legal structure of unit trusts, a switch by a unit holder is regarded as a disposal of one investment and the acquisition of a new one for tax purposes.

THE TAX POSITION

5. This section considers the tax position of

- offshore funds that have "distributor" status;
- offshore non-distributor funds;
- switches in UK unit trusts with different classes of units.

Offshore Distributor Funds

6. Distributor funds satisfy conditions which require them to distribute 100% of their income (as they define it) which must be at least 85% of what would be its UK taxable income if it were UK resident. On a share switch of the kind described above there is no charge, either to income tax or capital gains tax, on any accrued capital gain. Instead, there is CGT deferral until the investor eventually pulls out of the umbrella fund. (The switch comes within the CGT deferral provisions for share reorganisations, because the fund takes the form of a company). If the investor retains his involvement in the fund until he dies or becomes non-resident, the deferral of CGT on switching becomes effectively an exemption. Investors are subject to an income tax charge on any accrued but undistributed income at the time of the switch (generally income that has arisen to the fund since the last distribution date).

Offshore Non-Distributor Funds

7. These funds can accumulate their income. There is no charge on the investor on a switch of the kind described. On eventual disposal of the shares, there is an income tax charge on the full sale proceeds less the original cost. This replaces the CGT charge that would otherwise arise. The income tax charge was regarded as a substantial disincentive at the time it was introduced, but now that income tax and CGT are charged at the same rates, it is less onerous than previously. Many umbrella funds are in fact non-distributors

and marketed largely on the basis that the advantages of tax deferral on switches outweigh the disadvantage of the prospective income tax charge.

Switches between Classes of unit in UK trusts

8. When an investor switches from one class of units to another within an onshore umbrella unit trust, there is an immediate CGT charge on accrued gains. The investor is treated as having disposed of one investment and acquired another (as in substance he has).

Summary

9. Offshore umbrella funds enjoy a tax advantage because the CGT on changes of investment within the "umbrella" can be deferred until the investor finally sells or redeems his interest in the fund. An investor in a "distributor" fund has an income tax liability on accrued income at the date of the switch, but this does not cancel out the CGT advantage on accrued gains. An investor in a non-distributing fund pays no tax on a switch but faces an income tax liability rather than a CGT liability on eventual disposal of his interest in the fund. This may offset some of the benefit from the deferral of the tax charge on a switch, but it is less of a penalty now that income tax and CGT are charged at the same rates.

GROWTH OF OFFSHORE UMBRELLA FUNDS.

10. There is considerable evidence that the number of offshore funds and the value of funds invested in them has been growing in recent years. It is a fair assumption that the advantages of umbrella funds have played a part in this. In 1983 there was a total of 300 funds listed in Money Management (a magazine aimed mainly at UK investors) with an estimated £ 4.5 billion under their management. In 1987, the same source showed an estimated £ 11 billion under management in 721 funds. In June 1988, the number had grown again to 820, with an estimated £ 12 billion under management. We do not know how far these sums represent investment by UK residents, but it is reasonable to assume their share has grown at least in proportion to the overall amounts. Our own estimates are that there are currently about 500 offshore funds with distributor status marketed in UK, with a further 1000 non-distributor funds also available here.

11. This growth has been achieved without the automatic recognition in UK for EEC-based funds which will be available as a result of the UCITS directive. That directive can only fuel the growth of funds marketed in the UK by making it easier to gain regulatory recognition. Funds will no longer need to be tailored to meet UK regulatory requirements, as long as they satisfy their domestic regimes.

12. The unit trust industry has clearly lived with offshore competition for some time. The suggestion that they might now take fright and move offshore en masse might therefore be

regarded as alarmist. But there is no doubt that the competition is growing and that it is becoming more aggressively marketed at the UK investor. Many of these funds are, though based offshore, run by subsidiaries of UK management groups. Unless something is done, there is a likelihood of further major growth in offshore umbrella funds targeted at UK investors. This will be facilitated by the UCITS Directive.

A LEVEL PLAYING FIELD.

13. There are two options for achieving a level playing field, so far as the particular complaint about umbrella funds is concerned.

(i) Impose a tax charge on switches in offshore umbrella funds. In effect, this would mean bringing forward the charge that already arises on eventual disposal, to the extent that it is attributable to gains that had arisen before the switch occurs. The tax charge on eventual disposal would be correspondingly reduced.

OR

(ii) Remove the present capital gains tax charge on switches between units in UK unit trusts handled by the same UK managers.

14. The UTA want the tax treatment of switches in offshore funds to be brought into line with changes of investment in UK unit trusts. They are prepared to see this done by the imposition of a charge on investments in offshore funds. They are not seeking a new tax relief for investors in UK unit trusts. Some of the UTA's members who have already set up offshore funds may, of course, object to a charge on switching. But in view of the UTA's views as expressed to us, it is unlikely to come as a surprise if one were to be introduced.

15. If offered a choice, the UTA would no doubt prefer to have CGT exemption for investors in UK unit trusts. It would increase their competitiveness against other UK savings media, including direct investment. But they are not asking for an exemption. In short, they would be content to have option (i) above.

16. Option (ii) - exemption for UK investors on switching between units in UK unit trusts - would give unit trusts a new and potentially very attractive advantage over direct investment. It would seriously erode the CGT take on securities, by taking out of charge the switches that occur in unit trusts at present and by actively attracting new funds into unit trusts so as to benefit from the exemption. Umbrella funds would be developed to provide investors with a wide variety of types of sub-fund (including, under new rules to come into force, property sub-funds, money funds and the like). For corporate investors, umbrella funds would enable them to switch freely between types of investment while

deferring capital gains liabilities indefinitely. For individuals, deferral could be till death, at which point gains become exempt. As a result, there could develop a substantial reduction in the tax yield on gains on shares, securities and other investments. Investment trust companies and other savings media would no doubt press for comparable advantages.

17. It is only by accident - not intention - that switches within offshore umbrella funds fall within the CGT share reorganisation provisions and hence attract deferral. The deferral was introduced because with a normal share reorganisation the investor has effectively the same investment before and after. That is not true for umbrella fund switches, which by definition involve a major change in the nature of the investment.

18. The imposition of a charge on switching in offshore funds deals just as effectively with the competition point about which UTA complain. It is the route we recommend.

Nature of charge on switching

19. If Ministers accept our recommendation, there is a question as to the nature of the charge to be imposed. The question arises because of the distinction, under the present offshore funds legislation, between "distributor" and "non-distributor" funds.

20. Investments in distributor funds are at present subject to a capital gains tax charge on eventual disposal. In this case, we would be imposing a CGT charge on switching, which would have the effect of reducing the amount of the CGT charge on eventual disposal. This gives the right result. It may have the incidental benefit, for some investors, of enabling them to make use of their annual CGT exemption by switching at the appropriate time.

21. The position is different with non-distributor funds. Because these funds can roll up income, the present charge on eventual disposal is an <u>income tax</u> charge. It follows that the charge to be brought forward, and for which credit is given on eventual disposal, should also be an income tax charge. The argument would be that no change is being made to the <u>nature</u> of the charge, only its timing.

22. If a CGT charge were to be imposed on switches in a non-distributor fund, and the eventual income tax charge reduced correspondingly, it would allow an investor to switch just before eventual disposal, or periodically, in order to convert the income tax liability that arises under the present regime into a CGT liability.

23. A charge on switches will only affect people resident or ordinarily resident in the UK: others are exempt from CGT and the offshore funds charges. So the proposed treatment does not affect the attractiveness of umbrella funds - onshore or offshore - for foreign investors.

OFFSHORE FUNDS RESIDENT IN UK FOR TAX PURPSOES

24. We have recently seen a variation of the problems posed by umbrella funds. This was a proposal to establish an open-ended investment company located in the Channel Islands (their regulations permit open-ended investment companies). The conduct and management of the company would, however, be carried on from London, causing the company to be resident in UK for tax purposes. This means that the investor can benefit from the general CGT exemption for share reorganisation on switches, but is not subject to the offshore funds legislation. The rules for company distributions and Advance Corporation Tax, which apply in some circumstances to redemptions and exchanges of shares, also fail to deal properly with this situation.

25. The answer here, as with distributor funds, is to ensure there is a CGT charge on a switch, with appropriate reductions in the tax charges that arise on eventual disposal of the shares. This may be technically more difficult, because of the interaction with the company distribution rules in the case of UK companies. But we think we should be able to deal with those difficulties. If this particular problem is not addressed, it would allow the umbrella funds competitive problem to re-emerge through the device of gaining UK resident tax status for the offshore fund.

UNIT-LINKED LIFE ASSURANCE BONDS

26. There may be CGT-free switching possibilities with unit-linked life policies which allow holders to change the basis on which the bonds are valued between different types of unit. At present, this does not seem to be a serious problem, but there could be significant movement into this area if offshore umbrella funds were no longer specially attractive. This is an aspect we need to consider further. However, we think that Ministers may need to act on this as well, although not necessarily in 1989. But, if action is left over until later, it might be desirable to indicate that the area is being reviewed in order to restrain movement of funds out of offshore umbrella schemes into this alternative haven.

LENGTH OF LEGISLATION

27. This is likely to be about half a page for the imposition of a charge on switches in non resident funds. The legislation to deal with funds resident in UK for tax purposes would be a little longer - perhaps up to one page.

CONCLUSIONS

28. In summary, we recommend

- the imposition of a tax charge on switches in offshore umbrella funds;

- this should be achieved by bringing forward an appropriate part of the charge that already arises on the disposal of interests in offshore funds; and there should be an equivalent reduction in the eventual charge;

- in the case of distributor funds, this will be a CGT charge; in the case of non-distributor funds, it will be an income tax charge;

- these proposals deal with the competitive advantage offshore umbrella funds currently enjoy over UK unit trusts;

- to deal with the related problem of offshore registered umbrella funds which are resident in UK for tax purposes, we should aim to achieve the same answer as for offshore distributor funds, but the mechanisms will be different.

29. We believe these recommendations will be acceptable to the Unit Trust Association.

GEOFF NIELD

INTRO-
DUCTION

CONFIDENTIAL

Inland Revenue

Oil and Financial Division
Somerset House

FROM: A G NIELD

DATE: 9 December 1988

FINANCIAL SECRETARY

UNIT TRUSTS

I. INTRODUCTION

1. This note considers proposals for changing the basis on which certain types of authorised unit trusts are taxed. The Unit Trust Association made proposals for change in their letter to you of 3 August. Discussions with them revealed a number of difficulties and the UTA put revised proposals to us on 25 November. This note reflects these discussions. A separate paper attached deals with a related question of CGT charges on umbrella funds.

2. The paper first describes the current tax treatment of authorised unit trusts and "gilt" unit trusts. It then deals with the UCITS (Undertakings for Collective Investment in

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cc. PS/Chancellor	Chairman
Sir Peter Middleton	Mr Beighton
Mr Scholar	Mr Houghton
Mr Culpin	Mr Corlett
Mrs Lomax	Mr Pitts
Mr Ilett	Mr Johns
Mr Neilson	Mr Deacon
Mr Gilhooly	Mr McGivern
Mrs Chaplin	Mr Nield
Mr Tyrie	Mr Bolton
	PS/IR

Transferable Secuities) Directive that comes into force on 1 October 1989, describes the main types of continental funds that will be able to compete in the UK from that date, and the tax treatment accorded to them by their domestic tax laws. There need is then a Section on the need for change to the UK tax regime, the options available, who should qualify for any new regime, and our conclusions.

II. PRESENT TAX TREATMENT OF AUTHORISED UNIT TRUSTS

AUTHORISED TRUSTS EXCEPT "GILT" FUNDS

3. The present system for taxing authorised unit trusts (apart from gilt trusts) charges corporation tax on their income. Where this comes from UK dividends, liability is franked by the company which paid the dividends and no further tax is due. On other income - for example, Eurobonds, overseas securities or UK sources of taxed income - there is a mainstream corporation tax liability. Some of this liability sticks at the trust level and cannot be credited to the end investor. Any UK tax deducted at source (e.g. on gilts or debenture interest) is repaid and credit is given for foreign withholding taxes although these repayments and credits do not normally exhaust the mainstream CT liability. Individuals investing direct cannot get relief for the costs of managing their portfolio whereas unit trusts, like investment companies, get deductions for management expenses but not initial selling expenses. If there is insufficient unfranked income against which to set management expenses, ACT on the trust's dividend income is repaid.

4. The trust has to pay ACT on its income available for distribution to unitholders or for reinvestment on their behalf. This is either franked by UK dividends received by the trust or set against mainstream CT on other income. Unit trusts are exempt from CGT on disposals of investments: the unit holder pays CGT when he disposes of his units. Some disposals - in particular in the areas of futures and options - may be liable to tax as trading income.

"GILT" UNIT TRUSTS

5. Authorised units trusts whose rules restrict investments to UK interest-bearing securities are not subject to the above rules. They are taxed instead under an income tax regime, which also applies to unauthorised unit trusts. This makes the trustees liable to income tax (at the basic rate) on all the trust income from every source. Amounts distributed to unit holders (or rolled-up in the unit trust for their benefit) are income of the unitholders, on which income tax has already been paid.

6. The basic rate tax collected from the trustees therefore feeds through to unit holders as a corresponding credit. Only higher rate unit holders have any further tax liability and non-taxpayers can reclaim tax at the basic rate. The trustees are taxed on the gross fund income before management expenses or interest.

III. The UCITS Directive

7. The present tax regime has up to now worked satisfactorily. It has allowed the unit trust industry in the UK to grow. But this has been in the context of a protected UK market and one in which the predominant form of investment by unit trusts has been UK equities. The nature of the market will change from 1st October 1989, when the EEC UCITS directive comes into force. Thereafter qualifying investment vehicles authorised by the authorities of any member state will be able to market their units or shares freely throughout the Community subject only to compliance with the local marketing regulations of the receiving state.

8. An outline of the provisions of the Directive is attached at Annex [B]. The most important points are:-

a. The Directive relates only to collective investment schemes which invest in transferable (mostly quoted) securities. It does not apply to property funds or futures and options schemes, for example;

b. The UK schemes affected are authorised securities unit trusts;

c. The UCITS Directive does not apply to closed-ended companies (including investment trusts).

d. The Directive harmonizes the rules about (inter alia) permitted investment, redemption of units/shares and spread of investments.

e. It says nothing about tax.

9. The provisions of the UCITS Directive have been incorporated into UK law by the Financial Services Act (FSA). Collective investment schemes which are authorised in other EC States are automatically "recognised" in the UK and are freely marketable to the general public on a par with our own authorised unit trusts.

10. Luxembourg is the only other state so far to have legislated to recognise UCITS in their domestic regulatory laws. Everyone else must do so by 1 October 1989 except for Portugal and Greece who have a derogation until 1 April 1992.

IV. CONTINENTAL INVESTMENT VEHICLES

11. The concept of a trust is largely unknown on the continent and collective investment schemes generally take one of two forms:

a. open-ended investment companies; or

b. common investment funds

12. Both these kinds of collective investment vehicles are fiscally transparent in several European States (including

France, Germany and Luxembourg). Other countries (Netherlands and, possibly, Ireland) may be moving to a similar treatment in the run-up to UCITS commencement day.

13. Transparency usually take the form of exemption for the collective investment vehicles from tax on income and capital gains. Tax deducted at source before the income reaches the vehicle is not repaid (and the rate of this is sometimes higher than in the UK - e.g. US has no Tax Treaty with Luxembourg and so imposes a 30% withholding tax on income compared with 15% to the UK). No further tax is deducted at source when income is distributed to the investor, although so far as we can tell all the countries the UTA have drawn to our attention, except Luxembourg, impose withholding taxes on distributions to non-residents. The scheme participants pay tax on the distributions they receive in the same way as if they had invested in the underlying securities directly. There are of course variations on this pattern, e.g. Italy charges a "net worth tax" on the fund but exempts the participants. But, on the whole, the main EEC countries appear to offer transparency or to be contemplating it.

14. Annex B contains comparisons of the after tax income investors in the UK, France, Italy, and Germany would receive from UCITS in France, Italy, Germany, Luxembourg and UK.

V. THE NEED FOR CHANGES TO THE UK TAX REGIME

15. The UCITS Directive sets up two fields of new competition for UK authorised unit trusts:

a. the opportunity to export, selling to continental investors; and

b. inward competition from continental schemes seeking business in Britain.

16. The unit trust industry argues that changes to the tax rules are needed in order to meet the competition at home and

to take advantage of new opportunities in the EEC. They say that they need to be able to offer different types of units - in particular, bond funds which are popular on the continent - if they are to break into EEC markets. They will already have an uphill struggle to persuade intermediaries to offer their products. An inability to compete on even terms would make this worse.

(i) Nature of the problem

17. The problem arises from the corporation tax which is levied on the trust itself in excess of the amount credited to the unitholder in his eventual tax liability. There is no problem where the trust invests in UK equities: the ACT paid by the original company franks the ACT due on the distribution to the unitholder and no mainstream CT is payable. But other sources of income are liable to CT at 35% while the distribution to the unitholder bears a credit of 25% so there is 10% CT which is in addition to the tax which would be payable if he invested direct or through an EEC based fund. In the case of investments which have borne foreign tax at rates higher than 10% the sticking tax is higher: foreign taxes can be credited against mainstream corporation tax but not against ACT. On £100 US dividends, for example, £15 withholding tax will have been paid. This fully credits the mainstream CT liability but the trust can only distribute £63.75 with a tax credit of £21.25, giving a total of £85: the unitholder has thus suffered £15 extra tax compared with direct investment.

18. There is also a cashflow issue particularly for the non-UK investor. Sources of income which he can receive gross (or subject only to withholding tax which is below the basic rate of UK income tax) if he invests direct are converted to dividends, on which ACT has to be paid on their way through the unit trust. This does not normally result in permanent financial loss for the investor. Double taxation agreements allow payments of the tax credit to residents of most EEC countries, and withholding tax not repayable can usually be

set against the investor's domestic tax bill. And in the case of a German investor, there is at present a permanent financial loss, because we do not have a treaty with Germany that allows him to claim payment of the tax credit. This is a temporary problem, as we expect to negotiate a treaty giving dividend credits in the near future. But the investor has less money in his pocket for a time. The penalty is greatest for income paid gross such as Eurobond and deposit income but he will face some penalty on all interest. While for the honest investor this is purely a matter of timing, it can be a permanent loss for the taxpayer who does not report all his income.

19. A Luxembourg trust faces a 30% withholding tax on US dividends compared with 15% (under the UK/USA double taxation treaty) in the case of a UK trust. This works to the advantage of UK unit trusts, but the effect will usually only partially offset the extra sticking tax. It is nevertheless an advantage we must be careful not to lose as a result of any changes.

20. Our conclusion is that in some respects UK unit trusts suffer a significant tax disadvantage, by comparison with the industry's likely competitors on the continent.

(ii) Do the tax disadvantages matter?

21. Tax is only one of a number of factors affecting the competitive position. Marketing skills, investment record, and administrative efficiency may be just as important. Our guess is that the UK industry stands up well against continental schemes in these sorts of areas. But the balance is uncertain and we cannot be sure that overseas competitors do not have or will not acquire comparable skills and records. In that event, tax becomes a more significant factor. The UTA point out they will in any case have an uphill struggle to break into the continental marketing methods. They say that their liability to tax is a factor that overseas competition can play on for marketing purposes.

22. Perhaps as importantly, the UK industry may itself move offshore. The UTA's position is that many of their members would consider doing so in order to benefit from more favourable tax regimes. They might choose to do so in order to further improve their ability to gain market shares, even if their record and efficiency would enable them to compete from a UK base. Their products would be targeted back at UK investors (as we have seen happening with offshore umbrella funds) as well as at other EEC residents. This raises the prospect of home competition from firms with the advantages of a UK background and name, but with the benefit of overseas tax regimes.

23. On the whole, we accept that risks to the UK industry are real unless we can get fairly close to the tax treatment enjoyed by its competitors. If it were to move offshore, there could be longer term effects on London as a financial centre. And there would be some immediate effects on management fees earned and jobs in UK.

V. OPTIONS FOR CHANGE

OPTION 1: EXEMPTION OF UNIT TRUSTS

24. One option for change must be the UTA's proposal for exemption of the unit trust to parallel the similar exemptions for European equivalents. This raises a number of difficult issues:

a) Whether relief should effectively be given for management expenses and interest against the investor's tax despite the absence of any CT liability on the trust.

b) Whether tax should be withheld from distributions paid to investors.

c) How (if at all) withholding and other taxes deducted from income before it is received by the trust should be credited against UK investor's tax liabilities.

d) Whether the new regime should be optional or apply to all unit trusts.

e) What the implications are for other savings media.

(a)(i) Management Expenses

25. The present corporation tax regime for authorised unit trusts allows deductions for management expenses. An individual who invests directly in securities cannot obtain tax relief for the costs of managing his portfolio. Deduction is also denied to gilt unit trusts, who are subject to an income tax rather than a corporation tax regime.

26. The rationale of allowing relief to unit trusts was as a quid pro quo for being in the corporation tax regime. The argument was that a trust could have the costs and benefits of being regarded as a company - the costs being payment of mainstream CT; the benefit being deductions for expenses. Or it could be taxed at the basic rate of tax applicable to individuals, but in that event could not have reliefs denied to individuals. The current regimes for authorised unit trusts (who get CT treatment with reliefs) and for gilt unit trusts (who get income tax treatment, with no relief for management expenses) reflect this rationale. On the whole, the two regimes were regarded as giving broad parity of treatment with individual investors.

27. These arguments would still hold good if we were concerned with comparing different forms of UK investment by UK investors. But we are not. We are considering the effects of competition from countries where the fiscal approach is different. We have to recognise that continental regimes for UCITS tend to tax distributions to investors net of management expenses. The result is a conflict between matching the

continental tax systems and preserving the broad parity with direct investment at home.

28. The continental schemes will, of course, be able to sell their products in the UK. So the UK investor will have the choice of institutional forms of investment that benefit from deductions for management expenses, whatever decision is reached for UK unit trusts. A further point is that <u>in practice</u> the present UK tax regime for authorised unit trusts already allows the possibility of relief without a trust having any mainstream corporation tax liability. This can arise because a trust that only has franked investment income (i.e. dividends on UK shares) incurs no mainstream corporation tax, but can claim repayment of tax credits on dividends up to the amount of any otherwise unrelieved management expenses.

29. The UTA's position is that they will be unable to compete if they cannot deduct management expenses. They say that non availability of relief for management expenses has been a significant factor in inhibiting the growth of gilt funds.

30. Management expenses are certainly significant for unit trusts. They can amount to 25% or more of a trust's annual income. In aggregate, we estimate total annual management expenses for the industry to be around £300 million. The bulk of this gains relief under the present regime. The tax yield from withdrawing the relief could very well be greater than the tax saving, for existing trusts, from removing the CT penalty.

31. On balance, we recommend in favour of allowing management expenses to continue to be deductible under any new regime, on the grounds of meeting EEC competition, notwithstanding that it would give unit trusts an advantage compared with direct investment by the individual. But Ministers will want to weigh this up against their objective of not giving any more tax benefits to investment through institutions.

(a) (ii) Interest on borrowings

32. The present corporation tax regime for authorised unit trusts (but not the regime for gilt funds) allows the possibility of deductions for interest on borrowings. An individual who invests directly in securities cannot obtain tax relief for interest.

33. Unit trusts can borrow, although their powers are limited and, in some respects, fairly new. Some borrowing for hedging purposes is allowed, and recent changes to DTI regulations, bringing UK into line with the UCITS directive, allows borrowing to finance investment up to 10% of net assets, but limited to one month's investment expenditure.

34. Because unit trusts' powers were limited, the question of interest relief was probably not considered in any depth when the present tax regimes were introduced. But so far as there is any rationale for the present regime, it would rest on the same arguments as for management expenses. The arguments about competition from EEC based UCITS are also similar. But there are some additional points to be borne in mind.

35. The borrowing powers of unit trusts to finance investment are recent. We do not yet know what use the industry will make of them.

36. The ability to borrow and obtain tax relief is at present an important advantage enjoyed by investment trust companies over unit trusts. For reasons which we explain below, we do not recommend bringing investment trusts within any new regime. The dividing line between unit trusts and investment trusts will nevertheless be a difficult one to defend. It would help if investment trusts retained their advantage over unit trusts in this respect.

37. Individual investors are, we think, also likely to perceive interest relief as an important advantage by comparison with direct investment.

38. For these reasons, we recommend against allowing unit trusts to gain relief for interest on borrowing. The UTA will argue the overseas competition point, but not we think as strongly as on management expenses.

(b) <u>Deduction of tax at source on distributions to investors</u>

39. European collective investment vehicles do not collect any more tax at source from distributions to domestic unitholders beyond what has already been deducted before the income reaches the trusts. Some countries, in particular Luxembourg, do not make any deduction from distributions to non-residents while other countries impose a withholding tax on distributions to non-residents. To be fully competitive with the most beneficial regimes, therefore, a UK trust needs to be able to distribute income without any withholding tax. However, where UK investors are concerned it is necessary to operate a system which ensures that for the large majority of unitholders the right amount of tax is accounted for at source. This is because the UK tax system depends on most taxpayers not requiring an assessment at the end of the year. Any system which collected less tax than basic rate could lead to a substantial increase in the number of assessments and therefore of Inland Revenue staff. Where UK investors invest abroad (including foreign collective investment vehicles) the paying agent system should operate to achieve this. It is not completely effective but we would not see this as grounds for a system which does not collect basic rate tax from UK investors.

40. The UTA accept this so they propose that basic rate tax should be deducted from distributions paid to UK resident unitholders after credit for withholding tax borne by the trust. Non resident unitholders would, however, be entitled

to exemption from this basic rate charge on production of a certificate.

41. This is the system which is operated for composite rate tax. There are risks involved. It will be difficult for the unit trust to police residence certificates and even harder for them to police changes of residence by existing unitholders. Over time it can be expected that an increasing number of UK unitholders could be getting distributions gross - the honest would declare it and lead to additional assessments; the dishonest would have a convenient bolthole for their funds. But the UCITS directive already carries this risk if investors in foreign funds get round the paying agent rules. It is, of course, this sort of reason which has led the French to press for an EC wide withholding tax as part of the 1992 programme. In this context, it is possible that the introduction of a new UK regime that did not impose withholding tax could, at this stage, be seen as provocative.

42. Another corollary of this treatment is that if tax is no longer charged on the trust as such it would be very important to ensure that all the income was charged on the investors rather than rolled up tax free. Under the present rules ACT is chargeable on all the income which is shown to be distributable in the trust's accounts. While there will be regulatory rules which lay down to some extent how this is computed, the amount of income on which tax is paid would depend on the trust deed and the trust's accounting practices. Three particular points arising from this are:

- it would allow interest on borrowings to be deducted (as well as management expenses);

- accrued income on the sale of bonds may very well be treated as capital in the draft accounts;

- dealing in bonds that would normally be regarded as trading for tax purposes (and we understand from UTA this may be a real possibility with new bond funds) might be treated as being on capital account by the trust.

43. To deal with these points, we think we would need to define the trust's distributable income - for the purposes of deducting tax at source on payments or deemed payments to investors - as its income would be for corporation tax purposes if it were subject to that tax. In addition, if Ministers agree that no deduction could be allowed for interest on borrowings, this rule would have to be made specific.

(c) How should tax deducted at source from income received by trusts be credited against tax on distributions?

44. Under the UTA's approach, where the trust receives income from UK sources subject to deduction of tax at source, the trust should not be able to reclaim any tax so deducted, although it would be able to offset such tax against the amount the trust has to deduct from the distributions it makes. Distributions of income from the trust would be regarded as annual payments (this would be necessary to achieve the right mechanism for deduction of tax at source on distributions). This would have the effect, for the purposes of UK tax law, of converting all income, whatever its original source, into taxed income in the hands of UK investors. This, however, creates problems over dividends. Under normal ACT principles the tax credit attaching to the dividends would not be offsettable against tax deducted at source from an annual payment. This would, however, result in double taxation. The UTA's first solution to this was to take transparency a stage further and treat part of the distribution by the trust attributable to dividends received as a dividend (to which a tax credit was attached) and the rest as taxed income. This would cause enormous administrative problems for us and for the trusts. The UTA now recognise this. The most practical approach seems to us to breach normal ACT principles and set the tax credit on dividends received against tax on annual payments out. But this has the effect that franked investment

income received by the trust would no longer be franked investment income when it left the trust. This would be unattractive for many for corporate investors, for whom unit trusts would no longer be a source of franked investment income. The favourable tax regime for authorised unit trusts was not designed with corporate investors in mind but with the general public. However, life assurance companies in particular have invested in unit trusts in a big way for the capital gains tax advantages and the conversion of franked investment income into unfranked income might not always be attractive for them. The UTA now accept that this is inevitable (but this is one reason why they want the new basis to be optional).

45. Trust exemption would also have implications for the double taxation treatment of trust income received from abroad. At present, authorised unit trusts are allowed to offset overseas withholding taxes against their UK corporation tax bill. In effect, this relieves the investor in the unit trust of the need to become involved in double taxation issues.

46. The effect of making the trust exempt would mean the trust itself has no UK tax bill against which it could set overseas tax credits. Exemption for the trust would however bring the paying agents rules into effect. These require UK paying agents to deduct UK income tax at 25%, less any credit for overseas withholding taxes, from overseas sources of income before payment in UK. so the trust would received taxed income. The trust would be able to distribute the net amount it received. It would have to account for tax on the distribution and consider the extent to which this would be franked by the tax deducted by the paying agent or foreign Revenue.

47. There are some worries, shared by some members of the unit trust industry, that exemption could cause overseas revenue authorities to seek to impose higher rates of withholding tax on income due to the trust.

48. One approach would be to allow both to be credited against the tax deducted from the distribution to the investor. But this would mean that an exempt investor (like a pension fund) would be able to claim repayment of the full 25% tax accounted for by the unit trust even though, say, 15% represented foreign tax. Preventing this by restricting repayments to the 10% tax deducted by the paying agent would involve a complex administrative machinery. Moreover, it would open the way for companies which suffer from stranded ACT on account of double tax problems arguing that they should have the same treatment at considerable cost to the Exchequer and extra administration. It seems to us therefore that any credit would have to be limited to UK tax deducted at source. This would mean an element of double tax for a UK unitholder, but one no worse than exists under the present regime.

49. The UTA are aware of these potential problems and say that, from their point of view, they are prepared to live with them. The double taxation problems are, however, another major reason why the UTA want their proposed scheme to be optional. Their point is that the most likely candidates for their proposed regime are funds investing in Eurobonds and deposits. They see this as the major area of competition on the continent. For these types of funds, exemption gives the "right" answer because there is no withholding tax before the income reaches the fund. They recognise that their new regime can have disadvantages in relation to UK equities where they have corporate investors and (in the double taxation arena) third country equities. So they want individual trust managers to be able to opt to remain in the present regime if they see that as being more advantageous overall.

(d) Should the regime be optional?

50. We are not keen on having an optional regime. It raises questions about whether funds will be allowed to chop and change, when they have to elect to be in or out of the new regime, and so on. Moreover, neither we nor - we suspect - the UTA know how an existing unit trust would handle such an

option, given that some of their unitholders could benefit from one scheme and some from the other. But, like the UTA, we do not think the proposed regime would be acceptable to all unit trusts, particularly the unit linked life assurance sector. So we think that if this change were made it would have to be optional but further consideration would have to be given to how it might work. It might be necessary only to allow the new treatment for new unit trusts and to give them a once-for-all option on setting up. On the other hand this would cause serious tax penalties for unit linked life policies which would have to dispose of existing units, incurring a capital gains charge and invest in new trusts.

SECOND OPTION : TRUST LIABLE TO INCOME TAX

51. We have considered whether the problems would be solved by building on the gilts unit trust scheme and charging unit trusts to income tax but allowing relief for managerial expenses and finding some means of enabling payments to non-residents to be made without deduction of tax. However, any such scheme would face very similar problems to Option 1: it would involve some double taxation on foreign taxed income and would have to be optional. If you are attracted by this general approach we will review whether following an income tax rather than an exemption route would be technically superior but we do not at present see any major advantages in it.

THIRD OPTION: A 25% RATE OF CT

52. We have also considered the possibility of retaining the present corporation tax regime but reducing the rate of tax from 35% to 25%. The thought here is that the tax payable by a trust should then be fully covered by Advance Corporation Tax payable on distributions. So there ought to be no <u>additional</u> tax on the trust, over and above that for which it is liable to account on distribution.

53. The advantage of this option would be that it retains all the existing corporation tax rules and provisions for determining the trusts income, it retains the allowance for management expenses (although specific provision would have to be made for disallowing interest on borrowings, if Ministers agree that should be done). It would therefore be much simpler than the UTA's option. It would allow trusts to continue to claim double taxation relief for overseas taxes. The trust would remain a UK taxable body, which reduces the risk of overseas authorities trying to increase their withholding taxes. And distributions to non-residents would automatically fall into existing double taxation arrangements for dividends. It would leave the problem of stranded ACT on foreign income taxed at source unsolved; but we do not at present see a solution to this problem under any option.

54. There are two main disadvantages. First, it has the problem that income from sources paid gross, such as Eurobonds, would suffer deduction of tax on the way through the trust to non-residents, though this would be available for double tax credit in the hands of a foreign unitholder. The second main problem would be that UK corporate investors in unit trusts would effectively get unfranked investment income received by the trust converted into franked investment income received by them on which they would not have to pay mainstream CT. So it would pay them to receive any unfranked income via a unit trust to save 10% tax. We think under this option we would need to devise mechanisms to treat distributions as unfranked income in the hands of a corporate investor which is the proposal under Options 1 and 2. This would create a penalty for corporate investors. It might be possible to solve this by allowing distributions to corporate investors to remain franked income on production of a certificate from the unit trust setting out the extent to which it is derived from franked investment income received by them. But even this partial "looking through" the trust would add to the legislative and administrative complexity.

55. Apart from this last point, this option does not entail any disadvantages as against the present regime. And it is more beneficial - on management expenses - than the existing gilt funds regime. So it might be possible to avoid having optimal treatment and to simply the system by bringing gilt funds into the same regime.

VII. IMPLICATIONS FOR OTHER SAVINGS MEDIA

56. There are a number of savings media who may seek similar treatment to anything afforded to unit trusts. These are as follows:

(i) Non securities authorised unit trusts

57. The main categories of non securities funds will be:

a. money market funds - which put participants' money on deposit or invest in short dated gilts, bills of exchange, company loan stock etc;

b. property funds - investing in a range of real property;

c. futures and options funds - which seek to generate a return from operating in futures and options; and

d. mixed funds - investing in a mixture of the above as well as securities.

58. Apart from money market funds, none of these new style authorised unit trusts has yet been launched because DTI and SIB regulations are not yet in place. None of them are UCITS so the problem of European wide competition does not arise at this stage.

59. All these funds are taxed under the normal regime for authorised unit trusts. They enjoy CG exemption but face tax at corporation tax rates on income. Most of their income will be unfranked (interest earned by money funds, rents received by property funds etc).

60. Management expenses relief is available, of course, and foreign tax credits can generally be offset against the trustees' CT liability. Insofar as borrowing is permitted by DTI regulations (broadly 10% of fund) the trustees can deduct interest paid in computing their tax charge.

61. However, they all suffer the mainstream CT penalty and have been pressing to have this removed.

62. It may be possible for money funds to secure the non-CT "gilts" treatment but their promoters seem to assume not (and in any case they would then suffer the non-deductibility of management expenses under this regime). But these funds are not UCITS and the UTA's main point here is their wish to compete on even terms with UK banks and building societies for business in the UK. The admission of money funds to a new regime could introduce arguments about levelling competition between UK institutions. We think this would present Ministers with a more difficult dividing line to hold than if action is restricted to that necessary to meet foreign competition.

63. We have received representations from <u>futures and options funds</u> who say that they cannot get off the ground unless they are made immune from taxation as traders. The <u>property funds</u> have objected to the CT regime for authorised unit trusts as being generally inappropriate for unfranked income.

64. Ministers have already considered and refused these claims. The position of money funds and property funds was looked at in connection with the 1987 legislation on unit

trusts. Futures and options funds were examined more recently in response to representations from the Association for Futures Investments. If you decide to offer any of the options discussed above to securities funds you would need to look again at these funds. But they raise additional problems and we would recommend against any change this year on the grounds that the change is to deal with the consequences of the UCITS directive.

(ii) Approved Investment Trust Companies.

65. These are companies which are approved by the Inland Revenue and qualify for exemption from tax on capital gains. The main conditions for approval laid down in the Taxes Act are:

a. The investment trust income must be derived mainly from securities, and at least 85% of it must be distributed to shareholders;

b. No more than 15% of the investment trust's assets may be invested in one company; and

c. The investment trust company must be quoted on The Stock Exchange.

66. The conditions are intended to ensure that the investment trust - like an authorised trust - provides a broad spread of investments and is genuinely available for the ordinary public.

67. Authorised investment trusts are currently taxed on the same basis as authorised unit trusts. But they have an important regulatory advantage - with tax consequences - over unit trusts. Investment trusts can borrow and are often highly geared. The CT regime gives them relief for interest borrowings. Even now that new DTI rules allow authorised unit trusts to borrow, they will still be limited to 10% of their net assets. So interest relief will continue to be of greater

benefit to investment trusts. Especially so if Ministers agree that interest relief should not be allowed under any new regime for UCITS. We think investment trust companies will press strongly for comparable treatment to unit trusts but, as we have explained, closed funds are not covered by the UCITS directive and we suggest consideration should be deferred.

(iii) Investment Companies

68. Investment companies are ordinary companies whose business consists wholly or mainly in the making of investments and the principal part of whose income is derived therefrom. They pay corporation tax on their profits just like trading companies but qualify for relief against their taxable profits for expenses of managing their investments. They differ from authorised unit trusts and investment trusts in that their funds are not exempt from capital gains tax. If there were to be moves to admit approved investment trust companies into any new, more relaxed regime, ordinary investment companies could very well seek to follow suit. But they are a different type of animal, not aimed primarily at the ordinary public. The distinction between approved investment trusts and investment companies is in some ways akin to that between authorised and unauthorised unit trusts. DTI would almost certainly want us to reserve any relaxations for approved vehicles: and to do otherwise would just open the way to substantial avoidance because, outside the approved area, there is no control over the investment entity's activities. It would be necessary to examine very closely the boundary between investment media for the general public which justify transparent treatment and other investment vehicles like the generality of investment companies where there is no similar argument.

(iv) Life Assurance

69. Life assurance companies may see a numberof interactions with their affairs. They too are concerned about European competition and may ask why action should be taken for unit

trusts but not for them. The answer is that the UCITS directive comes into force in 1989, whereas harmonised regulation for life assurance is much further away in the future. They may say that moves towards transparency ought to be reflected in comparable moves for them. The life assurance consultative document in fact offered the route of looking through to the investor, but the life assurance industry reject this as impractical. Finally, they may say it is inconsistent to tighten up on the rules for management expenses whilst relaxing the rules in the case of unit trusts. The point here is that unit trusts do not get initial selling expenses now, and would not do so under our proposals. It is in this area that there are proposals to tighten up for life assurance. The type of expenses we are talking about for unit trusts are administration expenses, which are allowable in full for life assurance and there are no proposals to change this. So there is no inconsistency.

(v) Conclusions on who should qualify

70. Any relaxations for authorised securities unit trusts are likely to result in pressure for comparable treatment for other savings media. Unit trusts investing in things other than securities and Approved Investment Trust Companies are likely to be at the front of the queue.

71. The relaxations we think necessary to meet the UTA's points put the taxation of income from qualifying trusts in a more favourable position than direct investment, by allowing the investor to be taxed only on net income after payment of management expenses (and interest payments if relief for them were to be allowed). This is in addition to the CGT exemption that trusts already enjoy on share dealings. And they introduce the concept of a body that is exempt from income tax, which is bound to attract the attention of the tax avoidance industry. For both reasons, we think Ministers will, at this stage want to be very cautious about how far the relaxations should extend.

72. The argument that relaxations are necessary for unit trusts competing with UCITS in Europe provides what seems to be the strongest defensive line available against cries of "me too". Ministers would however have to be ready to say that their overriding concern is to meet competition in Europe, even if it means some unevenness at home.

73. Authorised investment trusts may, of course, say they are in competition in the UK with overseas based UCITS. The answer will have to be that, whilst this is true, they have some significant advantages over UCITS, including UK unit trust, in that they can borrow without the 10% restriction faced by UCITS, and obtain tax relief for interest on the borrowings. It might also be possible to say that the overall objective remains not to favour institutional investment over direct savings. It remains the intention to preserve that position, whilst making the minimum concessions necessary to compete in Europe.

74. Our recommendation is therefore that action this year should be restricted to vehicles qualifying as UCITS.

VIII CONCLUSIONS

75. We think that the UTA is right that the corporation tax charge on authorised unit trusts puts them at a competitive disadvantage compared with their European equivalents. They have faced growing competition from offshore funds (particularly in the Channel Islands) for some years but the coming into operation of the UCITS directive in October 1989 will increase the pressure which will come in future particularly from Luxembourg. Unfortunately the UTA's proposals, which we only received in final form on 25 November, give rise to a number of problems which are not easy to solve. These are

(a) possible problems with our EEC and Commission partners if we introduce a new scheme that does not impose a withholding tax on non-residents;

(b) unrelieved double taxation in the case of dividends received by trusts from overseas;

(c) conversion of franked investment income received by the unit trust into unfranked income (which would penalise corporate investors, particularly unit linked assurance);

(d) legislation that looks like being complex technically, in particular to allow UK tax deducted from income before it reaches the trust to feed through the end investor.

76. The UTA recognise the problems. They know their proposals could worsen the position of some trusts. Their answer is to have an optional scheme, which would allow trust managers to stay in the present regime if they prefer. We do not like this idea. It would add further to the complexity of the legislation, and it raises practical problems about the rules for servicing the option. We think the UTA do not themselves understand how managers would be able to decide to opt, particularly where they have different types of investor.

77. We have looked at alternative possibilities. None provide ideal answers in all circumstances. They all suffer from some unrelieved double taxation on income derived from overseas securities and all have the effect of changing the nature of some income on its way through the trust, either from franked investment income to taxed income or vice versa. We have however identified one route that:

(i.) suffers from no greater defects than the other options <u>except</u> that it would not be feasible to pay non-residents out gross (but we doubt that this is desirable anyway);

(ii.) appears to be much more straightforward legislatively.

78. This option, which we recommend, is to keep the present CT regime, but to reduce the rate of tax to 25%. This route allows management expenses without specific legislation, but provisions would be needed to disallow interest if Ministers agree that should be done. We would need to do further work on the penalty for corporate investors. We would hope to be able to avoid having an optional scheme, but at this stage we cannot be certain this will be possible. The problem for corporate investors, and therefore the need for an option, would be eased considerably if Ministers were to go for a 25% rate of tax on life companies.

79. Under all the schemes considered, we would propose to allow management expenses to be deducted, but disallow interest. On the scope of any new scheme, we recommend it should be restricted to open ended securities funds covered by the UCITS directive - at the cost of considerable pressure to widen the treatment to other unit trusts and to investment trusts.

GEOFF NIELD

ANNEX A

OUTLINE OF THE PROVISIONS OF THE UCITS DIRECTIVE

1. The UCITS Directive will harmonize with the laws applying to Undertakings for Collective Investment in Transferable Securities (UCITS). That is UK and Irish unit trust schemes and the continental varieties of contractual common funds and open-ended investment companies.

2. The Directive expressly excludes from its scope closed ended (i.e. fixed capital) funds and companies (such as investment trust companies) and UCITS which either do not promote their units to the public or are only promoted to the public outside the Community. Member States will also be able to exclude from the directive categories of UCITS for which the directive's detailed investment requirements are inappropriate (for example venture capital funds investing wholly or mainly in unquoted shares).

3. "UCITS" covers all entities which offer to invest the public's money in a spread of transferable securities and to redeem units, from the common fund, on request. The directive specifies in greater detail the requirements of UCITS in relation to such things as permitted investments, limits on investments and redemption provisions. Thus 90% of the portfolio of a UCITS must consist of quoted securities or securities traded on other recognised markets. No more than 5% of a UCITS assets may be invested in a single company, although an investment of up to 10% can be allowed, provided the total value of the securities in which a UCITS invests more than 5% does not exceed 40%. There are more relaxed limits for investment in Government Securities including a provision for funds investing 100% in gilts provided certain conditions are met. The directive would allow a UCITS to borrow up to 10% of the value of its net assets.

4. The Directive sets down certain minimum requirements concerning the structure of UCITS. It requires that the

assets of the fund be held by a depositary or trustee (separate from the manager) responsible for ensuring that money due to the fund is properly accounted for and that issue and redemption prices are calculated in accordance with the rules.

5. The Directive also requires a UCITS to circulate and keep up-to-date a prospectus giving sufficient information to enable a prospective investor to reach an informed judgement. The directive lays down the minimum contents covering such matters as the identity of those concerned with the UCITS affairs, the basic rules concerning the valuation of units and the redemption provisions and the investment policies to be followed by the UCITS. There is no requirement to provide accounting information in the prospectus itself, since there is a separate requirement concerning the basic framework of half yearly and annual accounts. These will be fairly straightforward, in view of the limited objects of the UCITS, and the rules are aimed at disclosure of the value and make up of the UCITS portfolio, the dealings in investments and units, and the dividends and other income accruing to the benefit of unit holders.

6. The prospectus and the most recent half yearly and annual accounts must be offered to potential investors before they invest and will also be open to inspection by the public. Unit holders will be entitled to copies of the accounts on demand (in the UK unit trust managers usually send the accounts as a matter of course to unit holders). Where a UCITS markets its units in another Member State it is required to distribute the prospectus and reports in at least one of the official languages of that country.

7. A Member State may adopt more stringent requirements than those laid down in the directive, but these would apply only to its own UCITS and not to UCITS based in other Member States, even when such UCITS are marketing units in the country concerned.

8. Member States will be able to lay down national rules concerning matters not dealt with in the directive - e.g. marketing and advertising rules. All UCITS will be obliged to comply with these local rules when they are marketing units.

COMPARISON OF AFTER TAX INCOME

ANNEX B

UK INVESTOR

CIV based in:-	Underlying Income: Deposits or bonds	3rd country securities	UK equities
UK current	585	563	900
France:			
-SICAV	675	563	675
-FCP	675	450	675
Germany	675	563	675
Italy	581	499	600
Luxembourg	675	450	675
UTA scheme	675	563	900

FRENCH INVESTOR

CIV based in:-	Underlying Income: Deposits or bonds	3rd country securities	UK equities
UK current	585	563	900
France:			
-SICAV	675	675	930
-FCP	675	675	930
Germany			
Italy			
Luxembourg	675	450	795
UTA scheme	675	563	900

GERMAN INVESTOR

CIV based in:-	Underlying Income Deposits or bonds	 3rd country securities	 UK equities
UK current	439	422	675
France: -SICAV -FCP			
Germany	675	675	675
Italy			
Luxembourg	675	450	675
UTA scheme	675	563	675

ITALIAN INVESTOR

CIV based in:-	Underlying Income Deposits or bonds	 3rd country securities	 UK equities
UK current	439 / 535 *	422 / 463 *	900
France: -SICAV -FCP			
Germany			
Italy	750	615	800
Luxembourg	675	450	675
UTA scheme	450 / 625 *	563 / 488 *	900

OTES: 1. These figures are based on source income of 1000 and assumed management expenses of 100.

2. * The second figure relates to UK authorised unit trusts which are also authorised in Italy, and as a result entitled to beneficial tax treatment.

CONFIDENTIAL

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

From: L J H BEIGHTON
12 December 1988

FINANCIAL SECRETARY

UNIT TRUSTS

In his note attached, Mr Johns is attempting to show in tabular form how the present system, the UTA's proposals and our alternative would work. You also asked for the issues requiring decision at the Chancellor's meeting to be set out. They seem to me to be:

1. Should we be prepared to make some alteration in the treatment of unit trusts in the light of the UCITS directive?

2. If so, should we try to compete with Luxembourg despite the risk of setting off a downward competitive spiral of tax regimes in Europe, the possibility of adverse reactions from the French and the European Commision and giving up benefits we have secured under double tax treaties?

---

cc Chancellor
Chief Secretary
Economic Secretary
Paymaster General
Sir Peter Middleton
Mr Scholar
Mr Culpin
Mrs Lomax
Mr Ilett
Mr Nielson
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Jenkins
(Parliamentary Counsel)

Mr Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Houghton
Mr McGivern
Mr Corlett
Mr Deacon
Mr Pitts
Mr Johns
Mr Bush
Mr Nield
Mr Fitzpatrick
Mr Reed
Mr M Haigh
Mr P Fawcett
Mr Cayley
Mr Kuczys
Mr J F Hall
Mr Bolton
PS/IR

3. Do you agree that relief should be provided for management expenses but not for interest?

4. The most important issue is the treatment of distributions by UK unit trusts to foreign investors. Do you agree these should be treated, as now, on normal CT and DT principles?

5. Do you agree that the 10% CT charge on the trusts which cannot be credited to investors should be removed?

6. Much of the rest is comparative detail on which further discussion with the UTA might be helpful. Subject to such discussions, the simplest way of achieving 4 and 5 above is probably to tax unit trusts to CT at 25%. Do you agree that the Revenue should work up such a scheme?

7. On umbrella funds, do you agree that a CGT charge should be imposed on switching within offshore funds and that a warning should be given that you are reviewing similar action on offshore life assurance?

LJHB

L J H BEIGHTON

Inland Revenue

Oil and Financial Division
Somerset House

FROM M A JOHNS

DATE 12 DECEMBER 1988

1. MR BEIGHTON
2. FINANCIAL SECRETARY

UNIT TRUSTS

At your meeting this morning you asked for a brief summary of how the existing system works and how the two main options for change (the UTA's and a 25% CT rate) differ.

I attach 3 tables which show for the present regime, the UTA's proposal and our alternative, the various stages at which tax is paid, repaid or credited and the end amount in the pockets of the three different types of investors - a UK individual, a UK company and a foreign individual.

You will see that in all three cases foreign taxed income is less advantageously treated than other sorts of income.

---

cc
Chancellor
Chief Secretary
Economic Secretary
Paymaster General
Sir Peter Middleton
Mr Scholar
Mr Culpin
Mrs Lomax
Mr Ilett
Mr Neilson
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Jenkins (Parliamentary Counsel)
Mr Battishill
Mr Isaac
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Mr Fitzpatrick
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Mr M Haigh
Mr P Fawcett
Mr Cayley
Mr Kuczys
Mr J F Hall
Mr Bolton
PS/IR

You will see that the UTA's scheme produces gross payment of income in the hands of the foreign investor for income which the trust receives gross. On UK dividends and UK taxed income they appear to accept that tax deducted at source before income reaches the trust and tax credits should not be repaid to the trust; but they appear to expect that they should be repaid to the non UK unitholder. I should say here that one of the problems which has bedevilled this issue is that the UTA themselves have been uncertain about what they propose in detail. They have some sympathy with the view that the UK should get some withholding tax on dividends but they are keen to avoid it on income which started as bond interest, and they recognise the administrative problems in a complex system of apportionment. In order to achieve what the UTA want, we would have to create a system which would necessarily entail the end-investor being able to reclaim all UK tax. Our own proposal produces the same income in the hands of the honest investor but after deduction of some UK tax at source which will be credited against his domestic tax.

The UTA's proposal puts the UK corporate investor in a worse position than under the existing regime for UK equities. A 25% CT rate alone would avoid this problem but put a UK corporate investor in a better position than the present system for UK taxed income and gross income. Because it would also put him in a better position than if he invested direct, however, we recommend treating the UK corporate investor in the same way as under the UTA scheme.

In short the only effective difference between the UTA scheme and our scheme is that the foreign investor gets income gross under their scheme and net of withholding tax under ours. Both schemes eliminate the 10% CT sticking charge on the trust which the present system imposes. Both convert franked investment income into unfranked investment income putting corporate investors at a disadvantage compared with the present system. We need to do more work to find the best way round the latter problem.

I also attach the country tables from Annex B of Mr Nield's note amended to show our recommended approach. The figures are not on all fours with those in the three main tables because the latter have been simplified by ignoring management expenses. The country tables takes account of them.

M. A. Johns

M A JOHNS

EXISTING SYSTEM FOR TAXING UNIT TRUSTS

Assumes income of 100 from each source. Management expenses ignored; so not comparable with figures in Mr Nield's note.

Source of income	UK Dividends	UK taxed income (eg Gilts)	Gross income (eg Eurobonds)	Foreign taxed income (eg US shares)
Tax withheld at source	None (but 25 paid by company - tax credit.	Basic rate 25	None	15% withholding tax
Tax chargeable on trust	None (franked investment income	Mainstream CT 35	Mainstream CT 35	Mainstream CT - after foreign tax credit - 20
Treatment of tax already borne	None	25 repaid	None	withholding tax set against mainstream CT as above
ACT on distribution to investor	25	22.5	22.5	21.25
Set off of ACT	against tax credit on dividend received.	against mainstream CT in full	against mainstream CT in full	20 against mainstream CT 1.25 stranded
In hands of UK individual investor	75 +25 tax credit	67.5 +22.5 tax credit	67.5 +22.5 tax credit	63.75 +21.25 tax credit
In hands of UK corporate investor	75 franked investment income	67.5 franked investment income	67.5 franked investment income	63.75 franked investment income
In hands of foreign investor (assume 15% with-holding tax)	85 +15 available for credit against foreign tax	76.5 +13.5 available for credit against foreign tax	76.5 +13.5 available for credit against foreign tax	72.25 +12.25 available for credit against foreign tax

UTA System

Source of income	UK dividends	UK taxed income	Gross	Foreign taxed income
Tax withheld at source	None (but 25 ACT paid by company; tax credit)	Basic rate 25	None	15 withholding tax
Tax chargeable on trust	None	None	None	None
Treatment of tax already borne	25 tax credit set against tax at source on distribution to UK unitholder; repayable to non-UK unit-holder	25 credited against tax at source on distribution to UK unitholder; repayable to non-UK unitholder	None	Left uncredited
Tax on distribution	25 - UK investor 0 - other	25 - UK investor 0 - other	25 - UK investor 0 - other	21.25 - UK Investor 0 - other
In hands of UK individual investor	75 +25 credit for tax withheld	75 +25 credit for tax withheld	75 +25 credit for tax withheld	63.75 +21.25 credit for tax withheld
In hands of UK corporate investor	75 unfranked investment income ie 65 after CT	75 unfranked investment income ie 65 after CT	75 unfranked investment income ie 65 after CT	63.75 unfranked investment income ie 55.25 after CT
In hands of foreign investor	75 + repayment of 25 tax credit	75 + repayment of 25 tax withheld	100	85

Our proposal

Source of income	UK dividends	UK taxed income	Gross	Foreign taxed income
Tax withheld at source	None (but 25 ACT paid by company; tax credit)	Basic rate 25	None	15 foreign withholding tax
Tax chargeable on trust	None	mainstream CT 25	mainstream CT 25	mainstream CT - after DT credit 10
Treatment of tax already borne	None	25 repaid	None	tax credit - as above
ACT on distribution to investors	25	25	25	21.25
Set off of ACT	Against tax credit on dividend received	against mainstream CT in full	against mainstream CT in full	only 10 against mainstream ACT; 11.25 stranded
In hands of UK individual investor	75 +25 tax credit	75 +25 tax credit	75 +25 tax credit	63.75 +21.25 tax credit
In hands of UK corporate investor if no special rule	75 Franked Investment Income	75 Franked Investment Income	75 Franked Investment Income	75 Franked Investment Income
But - in order to prevent avoidance treat as unfranked income	65 after CT	65 after CT	65 after CT	55.25 after CT
In hands of foreign investor	85 + 15 credit for withholding tax	85 + 15 credit	85 + 15 credit	72.25 + 12.25 credit

COMPARISON OF AFTER TAX INCOME

ANNEX B

UK INVESTOR

CIV based in:-	Underlying Income: Deposits or bonds	3rd country securities	UK equities
UK current	585	563	650
France:			
-SICAV	675	563	488
-FCP	675	450	488
Germany	675	563	488
Italy	581	499	431
Luxembourg	675	450	488
25% CT rate	675	563	650
UTA scheme	675	563	650

FRENCH INVESTOR

CIV based in:-	Underlying Income: Deposits or bonds	3rd country securities	UK equities
UK current	585	563	683
France:			
-SICAV	675	675	683
-FCP	675	675	683
Germany			
Italy			
Luxembourg	675	450	575
25% CT rate	675	563	683
UTA scheme	675	563	650

Note A

Figures for UK equities in each table have been revised to show position based on income of 1000 gross, before ACT; previous version was based on dividends of 1000 net, after ACT. New basis

GERMAN INVESTOR

CIV based in:-	Underlying Income: Deposits or bonds	3rd country securities	UK equities
UK current	439	422	488
France: -SICAV -FCP			
Germany	675	675	488
Italy			
Luxembourg	675	450	488
25% CT rate	506	422	488
UTA scheme	675	563	488

ITALIAN INVESTOR

CIV based in:-	Underlying Income: Deposits or bonds	3rd country securities	UK equities
UK current	439 / 535 *	422 / 463 *	488 / 650 *
France: -SICAV -FCP			
Germany			
Italy	750	615	575
Luxembourg	675	450	488
25% CT rate	506 / 625 *	422 / 463 *	488 / 650 *
UTA scheme	675 / 625	563 / 488	488 / 650

NOTES: 1. These figures are based on income of 1000 and assumed management expenses of 100.

2. * The second figure relates to UK authorised unit trusts which are also authorised in Italy, and as a result entitled to beneficial tax treatment.

3. The German Double Taxation treaty is likely to be renegotiated in a way that removes the advantage of UTA scheme over 25% CT rate scheme.

4. The figures assume any withholding taxes have been reclaimed or credited against domestic tax.

ILETT → FST 12/12.

fim2.cd/ilett/draft13 CONFIDENTIAL

FROM: N J ILETT

DATE: 12 December 1988

FINANCIAL SECRETARY

cc: Chancellor
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Riley
Miss Hay
Mr Neilson
Mr Ritchie
Mr Sharples
Mrs Chaplin
Mr Tyrie

Mr Beighton IR
Mr Bush IR
Mr Johns IR
Mr Pitts IR
Mr Neild IR
Mr Bolton IR
PS/IR

UNIT TRUSTS AND 1992

This note comments on the institutional background to the Inland Revenue's submission on unit trusts. The analysis is preliminary, given the time available.

2. "1992" is coming early for the unit trust industry; October 1989 for most countries, probably January 1989 for trade between the UK and Luxembourg (cf Mr Maude's recent letter, on which the Inland Revenue will be advising). In brief, the main questions seem to be:

(i) **Defensive.** What tax changes are needed, if any, to keep the UK unit trust industry competitive in present, UK market;

(ii) **Offensive.** What changes are needed to make UK trusts competitive in other Community countries;

(iii) What impact will tax changes under (i) or (ii) have on the competitive standing of unit trusts relative to other forms of investment in the UK markets - direct share and stock ownership, life assurance, and investment trusts?

(iv) Can we identify wider EC implications at this stage; eg for the debate on the taxation of savings or for these parts of the internal market which will be completed later?

The UCITS Directive

3. The Community regime for unit trust-type products is already pretty clear - unlike that for life assurance. From October 1989, the UCITS directive should enable "undertakings for collective investments in transferable securities" to trade throughout the Community. For the UK and Ireland, this means (most) securities unit trusts (but not investment trusts); for the Continental countries, who do not have trust law, it means open-ended investment companies. (The investor buys a new share and the company invests the money; and the reverse when he sells, so the issued share capital varies.) Significantly however the Community has done nothing to deal either with differing tax regimes or with differing marketing rules for UCITS. Both are left to host countries.

(i) Defensive tax changes - Luxembourg

4. Luxembourg has already implemented the UCITS directive. DTI Ministers have decided that they must now allow Luxembourg funds to be traded in the UK under the new regime. It is the threat of Luxembourg competition selling into the UK, and so of UK operations shifting to Luxembourg which makes the issues discussed in the Revenue paper immediate.

5. As the Revenue papers explain, the signs do not all point in the same direction. There is certainly no incentive for the UK

unit trust industry to depart en masse to Luxembourg. Specifically:

(i) Unit trusts which receive franked income, eg which invest mainly in UK equities, have no incentive to migrate;

(ii) Unit trusts with unfranked income which has been taxed in third countries are, in general, unlikely to want to migrate because Luxembourg has few double taxation treaties under which tax paid could be recovered;

(iii) Trusts with <u>un</u>franked <u>un</u>taxed income - typically those investing in fixed-interest euro securities - do have an incentive to migrate because Luxembourg does not tax them and does not deduct income tax at source, which appeals to tax evaders. But Luxembourg already has a competitive advantage in this business; what the UTA wants is to erode the existing advantage.

6. In practice, of course, many unit trusts have income from more than one of these sources. And the dishonest will almost always have an incentive to invest in Luxembourg funds, because of gross payment.

7. It is, of course, also relevant that there is not much room (left) in Luxembourg, costs are extremely high, and labour is scarce (one unit trust manager commented to us that the only workforce available was redundant French steelworkers from Lorraine). Arguably it would not much matter if all that moving to Luxembourg implied was a "brass plate" operation, like eurosterling issues. However, it would matter if the investment management teams moved, because this would reduce the critical mass in the UK. On the whole, we suspect that fears about Luxembourg are exaggerated; though we agree with the Revenue that a number of relatively modest changes - notably charging CT at 25% - do make sense.

8. The Luxembourg unit trust problem is the first "1992" financial services issue where Ministers have to measure the competing demands of fiscal considerations and of the competitiveness of the UK industry. As the life assurance lobby is already saying, there will be others. If we give the impression that the Government does not take representations of this kind seriously, there may be a row out of proportion to the facts of this particular case; and worries about the Government's readiness to listen to representations about 1992 in the future will increase. There is therefore a case for erring on the side of generosity on this occasion. This could (paradoxically) make it easier to stand firm on later occasions.

(ii) Offensive objectives - Opportunities in Community Markets

9. The trade press and people in the industry point to two reasons why it may be very difficult for UK funds to sell into other Community countries. First, distribution and marketing. With minor exceptions, savings products are sold by banks on the Continent, and banks only sell their own products. The independent advice sector on traditional UK lines is rare. So long as the UK independent sector continues to be significant, foreigners will have better opportunities here than UK firms abroad. And marketing rules are much stricter abroad - for example, the whole prospectus would have to be printed in a French newspaper, not just a coupon. (This is, of course, an example of the other side of the coin to our policy of insisting that host countries must have control over conduct of business rules in the proposed Investment Services Directive.)

10. Second, the concept of "unit trusts" is not generally understood on the Continent, and there are even doubts in the industry about how foreign tax administrations would treat them (we have not assessed whether these doubts are well founded). (Indeed, one UK unit trust company told us that they use a Luxembourg vehicle to sell open-ended investment company investments into Japan, because unit trusts cannot be sold in that country.) The DTI say there is no reason in principle why UK law

should not allow open-ended investment companies but there was no enthusiasm for this proposal when the DTI consulted before the Financial Services Bill, and major legislation would be necessary.

11. All this suggests that it may not be worth paying a high price in tax concessions to facilitate selling into Europe, so that our main objective is to keep our industry competitive in the domestic market.

(iii) Comparison with other UK savings

12. The Revenue paper notes that changes to the unit trust regime would have implications for direct ownership of shares and for other investment vehicles, notably life assurance. Unit trusts investing in UK equities would not, however, be affected in most respects. The implications for other UK savings media of any particular proposal will have to be taken into account on a case by case basis. There is no general solution. But if it is right that the main thrust of tax changes should be to make our industry competitive in the UK, then the case for treating UTs better than other vehicles, notably investment trusts, is weaker. A Continental UCITS will, after all, be in direct competition with both unit and investment trusts in the UK.

(iv) Wider EC Implications

13. As you know, we are doing further work on life assurance - but it is clear that harmonisation of life assurance products is a long way over the horizon. We cannot yet identify any read-across from UCITS to life assurance in the Community context.

14. There is, however, the vexed question of the taxation of savings. Clearly, there is a danger of a competitive downward spiral in the taxation of investment vehicles such as UCITS, and indeed of all types of saving, as member states cut into their tax systems to allow their investment management industry to offer the highest returns to savers. There could also be a competitive downward spiral in removing existing withholding taxes; it would

clearly infuriate some of our partners and damage the UK revenue if we moved towards gross payment to investors in unit trusts.

(v) Implications for tax proposals

15. This analysis has some obvious implications for the current tax proposals. If the key issue is defending the UK market, (rather than mounting an offensive on continental markets);

(i) The case for gross payment to non-residents becomes even weaker.

(ii) Investment trusts are just as vulnerable to increased competition as unit trusts, and therefore the case for limiting changes to unit trusts is weaker. Deductibility of interest payments for investment hardly compensates for a 10% higher tax rate.

(iii) The fact that non-UK UCITS will be competing in the UK market highlights the difficulty of concentrating concessions on UK UCITS. But if concessions are to go beyond UCITS, should they be less generous? In particular, does it make sense to charge tax at 25% and allow deductibility of management expenses?

NJ.

N J ILETT

Inland Revenue

Oil and Financial Division
Somerset House

FROM M A JOHNS
DATE 12 DECEMBER 1988

1. MR BEIGHTON
2. FINANCIAL SECRETARY

UNIT TRUSTS

At your meeting this morning you asked for a brief summary of how the existing system works and how the two main options for change (the UTA's and a 25% CT rate) differ.

I attach 3 tables which show for the present regime, the UTA's proposal and our alternative, the various stages at which tax is paid, repaid or credited and the end amount in the pockets of the three different types of investors - a UK individual, a UK company and a foreign individual.

You will see that in all three cases foreign taxed income is less advantageously treated than other sorts of income.

---

cc Chancellor
Chief Secretary
Economic Secretary
Paymaster General
Sir Peter Middleton
Mr Scholar
Mr Culpin
Mrs Lomax
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Mr Bush
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PS/IR

You will see that the UTA's scheme produces gross payment of income in the hands of the foreign investor for income which the trust receives gross. On UK dividends and UK taxed income they appear to accept that tax deducted at source before income reaches the trust and tax credits should not be repaid to the trust; but they appear to expect that they should be repaid to the non UK unitholder. I should say here that one of the problems which has bedevilled this issue is that the UTA themselves have been uncertain about what they propose in detail. They have some sympathy with the view that the UK should get some withholding tax on dividends but they are keen to avoid it on income which started as bond interest, and they recognise the administrative problems in a complex system of apportionment. In order to achieve what the UTA want, we would have to create a system which would necessarily entail the end-investor being able to reclaim all UK tax. Our own proposal produces the same income in the hands of the honest investor but after deduction of some UK tax at source which will be credited against his domestic tax.

The UTA's proposal puts the UK corporate investor in a worse position than under the existing regime for UK equities. A 25% CT rate alone would avoid this problem but put a UK corporate investor in a better position than the present system for UK taxed income and gross income. Because it would also put him in a better position than if he invested direct, however, we recommend treating the UK corporate investor in the same way as under the UTA scheme.

In short the only effective difference between the UTA scheme and our scheme is that the foreign investor gets income gross under their scheme and net of withholding tax under ours. Both schemes eliminate the 10% CT sticking charge on the trust which the present system imposes. Both convert franked investment income into unfranked investment income putting corporate investors at a disadvantage compared with the present system. We need to do more work to find the best way round the latter problem.

I also attach the country tables from Annex B of Mr Nield's note amended to show our recommended approach. The figures are not on all fours with those in the three main tables because the latter have been simplified by ignoring management expenses. The country tables takes account of them.

M. A. Johns

M A JOHNS

EXISTING SYSTEM FOR TAXING UNIT TRUSTS

Assumes income of 100 from each source. Management expenses ignored; so not comparable with figures in Mr Nield's note.

Source of incone	UK Dividends	UK taxed income (eg Gilts)	Gross income (eg Eurobonds)	Foreign taxed income (eg US shares)
Tax withheld at source	None (but 25 paid by company - tax credit.	Basic rate 25	None	15% withholding tax
Tax chargeable on trust	None (franked investment income	Mainstream CT 35	Mainstream CT 35	Mainstream CT - after foreign tax credit - 20
Treatment of tax already borne	None	25 repaid	None	withholding tax set against mainstream CT as above
ACT on distribution to investor	25	22.5	22.5	21.25
Set off of ACT	against tax credit on dividend received.	against mainstream CT in full	against mainstream CT in full	20 against mainstream CT 1.25 stranded
In hands of UK individual investor	75 +25 tax credit	67.5 +22.5 tax credit	67.5 +22.5 tax credit	63.75 +21.25 tax credit
In hands of UK corporate investor	75 franked investment income	67.5 franked investment income	67.5 franked investment income	63.75 franked investment income
In hands of foreign investor (assume 15% with-holding tax)	85 +15 available for credit against foreign tax	76.5 +13.5 available for credit against foreign tax	76.5 +13.5 available for credit against foreign tax	72.25 +12.25 available for credit against foreign tax

UTA System

Source of income	UK dividends	UK taxed income	Gross	Foreign taxed income
Tax withheld at source	None (but 25 ACT paid by company; tax credit)	Basic rate 25	None	15 withholding tax
Tax chargeable on trust	None	None	None	None
Treatment of tax already borne	25 tax credit set against tax at source on distribution to UK unitholder; repayable to non-UK unit-holder	25 credited against tax at source on distribution to UK unitholder; repayable to non-UK unitholder	None	Left uncredited
Tax on distribution	25 - UK investor 0 - other	25 - UK investor 0 - other	25 - UK investor 0 - other	21.25 - UK Investor 0 - other
In hands of UK individual investor	75 +25 credit for tax withheld	75 +25 credit for tax withheld	75 +25 credit for tax withheld	63.75 +21.25 credit for tax withheld
In hands of UK corporate investor	75 unfranked investment income ie 65 after CT	75 unfranked investment income ie 65 after CT	75 unfranked investment income ie 65 after CT	63.75 unfranked investment income ie 55.25 after CT
In hands of foreign investor	75 + repayment of 25 tax credit	75 + repayment of 25 tax withheld	100	85

Our proposal

Source of income	UK dividends	UK taxed income	Gross	Foreign taxed income
Tax withheld at source	None (but 25 ACT paid by company; tax credit)	Basic rate 25	None	15 foreign withholding tax
Tax chargeable on trust	None	mainstream CT 25	mainstream CT 25	mainstream CT - after DT credit 10
Treatment of tax already borne	None	25 repaid	None	tax credit - as above
ACT on distribution to investors	25	25	25	21.25
Set off of ACT	Against tax credit on dividend received	against mainstream CT in full	against mainstream CT in full	only 10 against mainstream ACT; 11.25 stranded
In hands of UK individual investor	75 +25 tax credit	75 +25 tax credit	75 +25 tax credit	63.75 +21.25 tax credit
In hands of UK corporate investor it no special rule	75 Franked Investment Income	75 Franked Investment Income	75 Franked Investment Income	75 Franked Investment Income
But - in order to prevent avoidance treat as unfranked income	65 after CT	65 after CT	65 after CT	55.25 after CT
In hands of foreign investor	85 + 15 credit for withholding tax	85 + 15 credit	85 + 15 credit	72.25 + 12.25 credit

COMPARISON OF AFTER TAX INCOME

ANNEX B

UK INVESTOR

CIV based in:-	Underlying Income: Deposits or bonds	3rd country securities	UK equities
UK current	585	563	650
France:			
-SICAV	675	563	488
-FCP	675	450	488
Germany	675	563	488
Italy	581	499	431
Luxembourg	675	450	488
25% CT rate	675	563	650
UTA scheme	675	563	650

FRENCH INVESTOR

CIV based in:-	Underlying Income: Deposits or bonds	3rd country securities	UK equities
UK current	585	563	683
France:			
-SICAV	675	675	683
-FCP	675	675	683
Germany			
Italy			
Luxembourg	675	450	575
25% CT rate	675	563	683
UTA scheme	675	563	650

Note A

Figures for UK equities in each table have been revised to show position based on income of 1000 gross, before ACT; previous version was based on dividend of 1000 net, after ACT. New basis provides proper comparison with other types of income.

GERMAN INVESTOR

CIV based in:-	Underlying Income: Deposits or bonds	3rd country securities	UK equities
UK current	439	422	488
France: -SICAV -FCP			
Germany	675	675	488
Italy			
Luxembourg	675	450	488
25% CT rate	506	422	488
UTA scheme	675	563	488

ITALIAN INVESTOR

CIV based in:-	Underlying Income: Deposits or bonds	3rd country securities	UK equities
UK current	439 / 535 *	422 / 463 *	488 / 650 *
France: -SICAV -FCP			
Germany			
Italy	750	615	575
Luxembourg	675	450	488
25% CT rate	506 / 625 *	422 / 463 *	488 / 650 *
UTA scheme	675 / 625	563 / 488	488 / 650

NOTES: 1. These figures are based on income of 1000 and assumed management expenses of 100.

2. * The second figure relates to UK authorised unit trusts which are also authorised in Italy, and as a result entitled to beneficial tax treatment.

3. The German Double Taxation treaty is likely to be renegotiated in a way that removes the advantage of UTA scheme over 25% CT rate scheme

4. The figures assume any withholding taxes have been reclaimed or credited against domestic tax.

GILHOOLY
→ CHEX
12/12.

fp.pk/division/jfg12.12.1

CONFIDENTIAL

FROM: J F GILHOOLY
DATE: 12 December 1988
cc: Financial Secretary
Economic Secretary
Sir Peter Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mrs Lomax
Mr Ilett
Mr Neilson
Mr J M G Taylor
Mrs Chaplin
Mr Tyrie

Mr Battishill)
Mr Johns)
Mr Nield)
Mr Painter) Inland
Mr Lewis) Revenue
Mr Farmer)
Mr Isaac)
Mr Corlett)
Mr Kuczys)

CHANCELLOR

Ch.

Questions on pages 5-7.

JF 12/12

UNIT TRUSTS

You may like to have an Annotated Agenda for the unit trusts section of your meeting this afternoon.

2. The papers are:

- **Neild of 9 December on "Unit Trusts"**
- **Neild of 9 December on "Umbrella Funds"**
- **Cover note (Johns) of 9 December**
- **Beighton/Johns of 12 December**
- **Ilett of 12 December**

3. The genesis of all this is the proposals the Unit Trust Association has made to deal with what they see as the tax disadvantages they will suffer in comparison with competitors, especially Luxembourg-based ones, once UCITS is in place (1 October 1989, early 1989 for Luxembourg).

Present System

4. UK unit trusts are subject to Corporation Tax at 35%, but distribute their "dividends" with the usual 25% credit. (They are not subject to CGT.)

5. The diagram at Annex A sets out the present system, showing how the four basic sorts of investment return (franked UK dividends; taxed UK securities (gilts etc); income received gross from e.g. Eurobonds; and foreign dividends, e.g. from the USA, which have paid a foreign withholding tax) are taxed in the case of the three main types of investor (UK residents; UK resident companies; and foreigners). The Annex compares the tax treatment of investments made direct, with that of the same investments made through a unit trust. (Mr John's minute of ~~9~~ 12 December sets this out more fully.)

6. Annex A shows that (putting management expenses to one side) for many combinations of investor and investment, the tax treatment <u>via</u> a unit trust is the same as investing directly (give or take timing differences in when tax is paid). But differences arise for non-corporate investors investing in a unit trust which receives some or all of its income other than in the form of UK dividends. In particular,

(a) the 10% difference between the 35% CT paid by the unit trust and the 25% basic rate income tax credit given to the investor sticks for both UK residents and foreigners; and

(b) Unit trusts cannot offset foreign withholding tax against ACT. As a result, where there is a foreign withholding tax of over 10% (for example 15%) this sticks in the unit trust, so that UK resident investors are in this example 15% worse off than if they had invested directly (when they could have used the withholding tax paid to offset their UK tax bill).

(c) for foreigners, an effect like (b) can also operate. Whether it does or not depends on the nature of the DTA between their country of residence and the country levying the withholding tax.

The UTA proposal

7. The UTA proposal is to exempt unit trusts from CT/ACT making them totally transparent. However, this does not look a sensible way forward, because of the complexity involved for the unit trusts, the investor and the Revenue (paragraphs 44 to 46 of Mr Neild's note). It is also unattractive:

- in terms of our existing DTAs; which are based on the fact that we do not tax dividends and non-residents can only reclaim if their fiscs are informed;

- because no tax would be paid to the Exchequer by non-residents;

- and because it would be provocative towards the French and the Commission. They would see it as dismantling part of the existing withholding tax system.

Revenue proposal

8. The Revenue's proposal attempts to achieve the same general objective as the UTA, but by a different route.

9. They would leave the present taxation of unit trusts in place, but reduce the CT rate to 25 per cent. That solves 6 (a) above.

10. Reducing the CT rate would not solve the problems at 6 (b) and 6 (c) above: the foreign withholding taxes would still affect the return to both UK and foreign residents, so that the return net of UK and foreign tax would stay the same. But investors would benefit under (a).

11. The Revenue estimates the cost of reducing the CT rate for unit trusts at about £20 million.

12. As the Revenue submissions bring out, this change would however create a new problem, in respect of Corporate investors in unit trusts. It would create for UK companies a source of investment income which would be taxable at 25 rather than 35 per cent. The Revenue are considering further how this should be dealt with. In his note of 12 December, Mr Johns suggests a solution which would - as he points out - have the side effect of putting ~~in~~ the corporate investor in a worse position when investing in UK equities via unit trusts than when investing directly.

13. There are two final issues:-

(a) relief for interest paid by the unit trust on its borrowing (if any) to purchase securities.

(b) relief for management expenses.

The Revenue advice would be strongly against giving relief for (a); but unless relief is given for (b) - which puts unit trusts ahead of direct investment - there would be no advantage to the UTA inmaking the change.

POINTS FOR DISCUSSION

Q.I **Does something need to be done?**

Issue here is whether UTA fears about their competitiveness after onset of UCITs (1 October 1989) are right, and substantial enough for action on tax front. Is this about maintaining competitiveness in our own market or also about going seriously for new EC markets? See Ilett, 12 December.

Q.II **Does something need to be done this year?**

Marketing unit trusts in newly opened European markets will take time to build up. Even if answer to QI is "yes", is there real urgency, requiring action in 1989 Finance Bill?

Q.III **Do you agree Revenue proposals preferable to UTA's?**

See Beighton 12 December, especially points 3 to 6.

Q.IV **Are the Revenue proposals the minimum that needs to be done?**

E.g. Would it be enough on competitiveness grounds to reduce CT rate for unit trusts to 30 per cent?

Q.V **How far should we go?**

Both the UTA and Revenue proposals involve significant changes in the tax burden, and sacrificing revenue which has been gained to the Exchequer via DTAs.

Can we go as far as the Revenue proposals do without

(i) triggering a Dutch Auction of tax rates elsewhere in Europe?

(ii) enraging the French and their supporters and the EC Commission, who are seeking a Europe-wide withholding tax system?

See Beighton, Johns, Ilett of 12 December.

Q.VI **Repercussions**

- How does this fit with proposals for PEPs, also being discussed at you meeting?

- How does it fit with Life Assurance proposals? How does it affect Life Offices (who make considerable use of unit trusts)?

- How do we defend a concession to UTA on "1992" grounds, when resisting "1992" arguments from others (e.g. Life Offices)? ?Is 1989

- How will claims for similar treatment from other (non-securities) unit trusts and from investment trusts be resisted (assuming they should be)?

- Does this tip things too far towards institutional investment?

UMBRELLA FUNDS

14. The problem here is that by using an offshore fund an investor can switch his investments without paying CGT. UTA has suggested legislation to bring offshore funds tax treatment in line with that for onshore funds. The UTA was

neutral as between levelling up or levelling down. The Revenue (Neild of 9 December) recommend applying IT/CGT in the case of offshore funds, as already applies to onshore funds, i.e. levelling up. (Note that acting on offshore funds may require similar action for offshore life assurance.)

Q.VIII Do you agree this problem is serious enough to require legislation in the 1989 Finance Bill? If so, are you content with Revenue's approach?

J F GILHOOLY

Annex A

STATUS OF INVESTOR

SOURCE OF INCOME	UK RESIDENT INDIVIDUAL		UK RESIDENT COMPANY		NON-RESIDENT INDIVIDUAL	
	DIRECT	VIA UNIT TRUST	DIRECT	VIA UNIT TRUST	DIRECT	VIA UNIT TRUST
UK DIVIDENDS	DIVIDEND HAS 25% CREDIT ATTACHED	DIVIDEND PLUS 25% CREDIT FLOWS THROUGH NO ADDITIONAL TAX IN TRUST	DIVIDEND RECEIVED FRANKED BY ACT CREDIT	FRANKED DIVIDEND FLOWS THROUGH TO COMPANY NO ADDITIONAL TAX IN TRUST	RECEIVES DIVIDEND PLUS CREDIT, MUST DTAs ALLOW CREDIT R/PMT LESS WITHHOLDING TAX WHICH MAY OFFSET "HOME" TAX LIABILITY	RECEIVES DIVIDEND PLUS CREDIT. CREDIT FLOWS THROUGH TO INVESTOR. TREATMENT OF CREDIT AS FOR DIRECT INVESTMENT
	COMPARABLE TAX TREATMENT		COMPARABLE TAX TREATMENT		COMPARABLE TAX TREATMENT	
UK TAXED INCOME EG INTEREST	INCOME RECEIVED NET OF BASIC RATE TAX AT 25%	(1) TRUST IN EFFECT PAYS CT AT 35% DISTRIBUTES WITH 25% CREDIT 10% TAX STICKS	PAYS CT AT 35%	UNIT TRUST PAYS CT AT 35% DISTRIBUTES TO COMPANY WITH 25% CREDIT. COMPANY PAYS NO FURTHER TAX	RECEIVES INCOME LESS WITHHOLDING TAX OF 0, 15% OR 25% DEPENDING ON DTA MAY BE ABLE TO OFFSET TAX WITHHELD AGAINST "HOME" TAX	TRUST IN EFFECT PAYS CT AT 35% DISTRIBUTES WITH 25% CREDIT 10% TAX STICKS CREDIT R/PD LESS WITHHOLDING TAX WHICH MAY BE RELIEVED AGAINST HOME TAX
	DIRECT INVESTMENT LESS HEAVILY TAXED		COMPARABLE TAX TREATMENT		DIRECT INVESTMENT LIKELY TO BE LESS HEAVILY TAXED	
INCOME PAID GROSS EG EUROBONDS	INCOME RECEIVED GROSS, CHARGEABLE TO INCOME TAX	TRUST RECEIVES INCOME GROSS CHARGEABLE TO CT AT 35% DISTRIBUTES WITH 25% CREDIT 10% STICKS	INCOME RECEIVED GROSS CHARGEABLE TO CT AT 35%	TRUST RECEIVES INCOME GROSS SUBJECT TO CT AT 35% DISTRIBUTES WITH 25% CREDIT	INCOME RECEIVED GROSS NO UK TAX LIABILITY	TRUST RECEIVES INCOME GROSS CHARGEABLE TO CT AT 35% DISTRIBUTES WITH 25% CREDIT 10% TAX STICKS MAY GET REFUND OF CREDIT SUBJECT TO WITHHOLDING TAX.
	DIRECT INVESTMENT LESS HEAVILY TAXED		COMPARABLE TAX TREATMENT		DIRECT INVESTMENT LIKELY TO BE LESS HEAVILY TAXED	
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(1) TRUST GETS REPAYMENT OF INCOME TAX PAID AT SOURCE (25%) AND PAYS CORPORATION TAX AT 35% ON GROSS AMOUNT

(2) x x x INDICATES BOX IN WHICH UNIT TRUST INVESTOR LESS FAVOURABLY TREATED THAN DIRECT INVESTOR

Note: this table ignores availability of relief for management expenses of unit trust. This works in favour of investment through unit trust compared with direct investment.

BEIGHTON 7
FST 12/12

CONFIDENTIAL

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

From: L J H BEIGHTON
12 December 1988

FINANCIAL SECRETARY

UNIT TRUSTS

In his note attached, Mr Johns is attempting to show in tabular form how the present system, the UTA's proposals and our alternative would work. You also asked for the issues requiring decision at the Chancellor's meeting to be set out. They seem to me to be:

1. Should we be prepared to make some alteration in the treatment of unit trusts in the light of the UCITS directive?

2. If so, should we try to compete with Luxembourg despite the risk of setting off a downward competitive spiral of tax regimes in Europe, the possibility of adverse reactions from the French and the European Commision and giving up benefits we have secured under double tax treaties?

---

cc Chancellor
Chief Secretary
Economic Secretary
Paymaster General
Sir Peter Middleton
Mr Scholar
Mr Culpin
Mrs Lomax
Mr Ilett
Mr Nielson
Mr Gilhooly
Mrs Chaplin
Mr Tyrie
Mr Jenkins
(Parliamentary Counsel)

Mr Battishill
Mr Isaac
Mr Painter
Mr Beighton
Mr Houghton
Mr McGivern
Mr Corlett
Mr Deacon
Mr Pitts
Mr Johns
Mr Bush
Mr Nield
Mr Fitzpatrick
Mr Reed
Mr M Haigh
Mr P Fawcett
Mr Cayley
Mr Kuczys
Mr J F Hall
Mr Bolton
PS/IR

3. Do you agree that relief should be provided for management expenses but not for interest?

4. The most important issue is the treatment of distributions by UK unit trusts to foreign investors. Do you agree these should be treated, as now, on normal CT and DT principles?

5. Do you agree that the 10% CT charge on the trusts which cannot be credited to investors should be removed?

6. Much of the rest is comparative detail on which further discussion with the UTA might be helpful. Subject to such discussions, the simplest way of achieving 4 and 5 above is probably to tax unit trusts to CT at 25%. Do you agree that the Revenue should work up such a scheme?

7. On umbrella funds, do you agree that a CGT charge should be imposed on switching within offshore funds and that a warning should be given that you are reviewing similar action on offshore life assurance?

L J H BEIGHTON

fp.pk/division/jfg12.12.1

CONFIDENTIAL

PWP

FROM: J F GILHOOLY
DATE: 12 December 1988
cc: Financial Secretary
Economic Secretary
Sir Peter Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mrs Lomax
Mr Ilett
Mr Neilson
Mr J M G Taylor 12/2
Mrs Chaplin
Mr Tyrie

Mr Battishill)
Mr Johns)
Mr Nield)
Mr Painter)Inland
Mr Lewis)Revenue
Mr Farmer)
Mr Isaac)
Mr Corlett)
Mr Kuczys)

CHANCELLOR

Pse type as draft. Thanks

JL

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J F GILHOOLY

Annex A

STATUS OF INVESTOR

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INCOME PAID GROSS EG EUROBONDS	INCOME RECEIVED GROSS. CHARGEABLE TO INCOME TAX	TRUST RECEIVES INCOME GROSS CHARGEABLE TO CT AT 35% DISTRIBUTES WITH 25% CREDIT 10% STICKS	INCOME RECEIVED GROSS CHARGEABLE TO CT AT 35%	TRUST RECEIVES INCOME GROSS SUBJECT TO CT AT 35% DISTRIBUTES WITH 25% CREDIT	INCOME RECEIVED GROSS NO UK TAX LIABILITY	TRUST RECEIVES INCOME GROSS CHARGEABLE TO CT AT 35% DISTRIBUTES WITH 25% CREDIT 10% TAX STICKS MAY GET REFUND OF CREDIT SUBJECT TO WITHHOLDING TAX.
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(1) TRUST GETS REPAYMENT OF INCOME TAX PAID AT SOURCE (25%) AND PAYS CORPORATION TAX AT 35% ON GROSS AMOUNT

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Note: this table ignores availability of relief for management expenses of unit trust. This works in favour of investment through unit trust compared with direct investment.

MINUTES OF A MEETING HELD IN THE CHANCELLOR'S ROOM HM TREASURY, AT 4.30PM ON TUESDAY 13 DECEMBER 1988

Present: Chancellor of the Exchequer
Financial Secretary
Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mr Matthews
Mr MacPherson
Mr Neilson
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Battishill - IR
Mr Isaac - IR
Mr Beighton -IR
Mr Painter - IR
Mr Corlett - IR (Item 1)
Mr Kuczys - IR (Item 1)
Mr Lewis - IR (Item 2)
Mr Cayley - IR (Item 2)
Mr Farmer - IR (Item 2)
Mr Johns - IR (Item 3)
Mr Nield - IR (Item 3)
Mr Fawcett - IR (Item 3)

Item 1: Personal Equity Plans

Papers: Mr Gilhooly's annotated agenda of 9 December; Mrs Chaplin's note of 12 December; Mr Tyrie's note of 12 December; Financial Secretary's note of 6 December; Mr Kuczys/Walker note of 30 November; Mr Kuczys' note 16 November; Mrs Lomax/Mr Neilson note of 17 November.

Opening the discussion, the Chancellor said there was a range of possibilities for action: "Capital PEPs";some variant of the Barclayshare scheme; and some form of front end relief. There were also a number of proposals for simplifying the present arrangements for PEPs, which could be combined with any of these possibilities. Alternatively, no action could be taken. He had, however, reached the conclusion that some positive changes should be made. But we would need to be confident that any such changes would have a real impact.

2. The Financial Secretary agreed that action should be taken. Which route to take would depend on how much we wished to adhere to the original objectives of the PEP Scheme. Capital PEPs, he thought, carried a lot of deadweight and would be difficult to defend. The Barclayshare approach also carried deadweight. His preferred approach would be to combine some form of front end relief with an increase in the unit trust/investment trust limit. These would encourage much greater marketing, both of existing schemes and of new schemes.

3. In discussion, the following points were made:

(i) Increasing the unit trust/investment trust limit would not help to encourage direct shareholdings. It might also sit oddly with front end relief, which would be designed to encourage direct holdings. On the other hand, increasing the unit trust/investment trust limit could be presented as directed specifically at the smaller investor;

(ii) the choice of route was crucially dependent on the objective. The Chancellor confirmed that this objective was to seek to redress the savings balance in the Budget by doing something to promote wider share ownership, rather than savings in general;

(iii) there were risks in using a tax route - front end relief - to encourage investment in equities in the face of market pressures in the opposite direction. It was doubtful, also, that there was a level of subsidy big enough to encourage PEPs yet small enough to avoid "round tripping". An exit charge also carried considerable disadvantages;

(iv) relaxing the limits for unit trusts and investment trusts would diffuse the objectives of PEPs. The Barclayshare approach, on the other hand, was simple and mirrored a feature of the changes proposed for pensions (ie separating the limits for tax relief from the more general limits);

(v) a longer holding-in period might be considered in exchange for a relaxation of limits. But this could have a locking-in effect. Other variants could be to the amount of relief - full or partial - and the level of monetary limits. If the limit for tax relief were at a lower level than the monetary limit for investment in a PEP, however, this could have behavioural effects on the amount which potential investors would put into their PEPs;

(vi) the presentational implications of any changes would need to be considered carefully. For example, front end relief might sit oddly with the possible changes envisaged for life assurance;

(vii) the various approaches would appeal to different types of investors. Barclayshare, for example, would be more attractive to those with larger holdings. It was doubtful whether it would widen share ownership very much;

(viii) the present distinctions between discretionary PEPs, and non-discretionary PEPs should be borne in mind. Most PEP investors were in discretionary schemes. These were de facto small unit trusts. Consideration could be given to designating only certain types of shareholding (eg UK, or EC equities) as eligible for inclusion in a PEP;

(ix) if the unit trust limits were raised, there was a possibility that direct investment in equities via PEPs could, to some extent, be driven out. However, this needed to be balanced against the market realities. Current market conditions were unfavourable to direct investment in equities; when conditions improved, there would be an incentive for PEP promoters to push direct investment more strongly.

4. Summing up, the Chancellor concluded that the following approach should be pursued. Existing PEPs should be retained. The limit for holding should be increased to £3,600 a year. Within that total, up to £2,400 could take the form of investment in unit or investment trusts. Eligible unit and investment trusts should be confined to those investing in UK equities (advice should be sought on how long this limit might last). New issues should be able to be put straight into a PEP; they should be set off against the direct equity holding if the full unit trust entitlement had been taken up. The various simplifications suggested in the papers should also be pursued, to the extent consistent with these other parts of the package. This was agreed.

Item 2: Employee share schemes/ESOPs

5. The Chancellor noted that increasing the existing limits on employee share schemes to £6,000 would help to slant relief towards the lower paid. It was agreed to raise the limit to £6,000.

6. The Financial Secretary said that an ESOP differed from a profit share scheme. It was, essentially, a scheme whereby

employees could be enabled to own a significant share of the business in which they worked. This share might, subsequently, be part of a controlling proportion of the shares. The arguments in favour of ESOPs were set out in the papers. He recognised that ESOPs in the United States had led to abuse - eg in their use as "poison pills" to prevent takeovers. He would not, therefore, wish to go as far as proposed by the JOL or the ESOPs Centre. At the minimum, he favoured action which did not require substantive changes to the present law: solving the material interest problem of JLP, and allowing deductibility from corporation tax for an ESOP. He also favoured, however, CGT roll-over relief for ESOPs.

7. The Chancellor agreed that it was sensible to make some changes here. These would assist, especially, the unquoted companies sector. Mr Painter noted that there would, however, be some difficulties with the proposals. In particular, allowing CGT roll-over relief might provide a route for proprietors to avoid tax charges on their capital gains, by cycling their shares through the trust.

8. In further discussion, the Chancellor said that he did not envisage any changes to ESOPs as part of a high profile attempt to alter the playing field. Instead, they would be intended merely to remove obstacles in the way of proprietors who wished already to move in this direction.

9. Summing up, the Chancellor said that action should be taken to solve the JLP material interest problem. The Revenue could discuss this in confidence with JLP to ensure that any action taken met the objective. Action should also be taken to make certain that payments made by companies in their ESOPs were deductible for corporation tax purposes. The statutory definition of the type of trust which would benefit should be drawn up in the simplest possible way. He also invited the Financial Secretary to examine, first, whether employees could be allowed to offer shares

a discount to the market price without triggering the provisions of benefits-in-kind tax legislation. Finally, he invited the Financial Secretary to consider further the possibilities for allowing CGT roll-over relief. A decision on this aspect would be taken at a later stage.

Item 3: Unit trusts

10. Following a brief discussion, it was agreed that the CT rate for unit trusts should be reduced to 25%. Unit trusts should also be given relief for their management expenses.

J M G TAYLOR
Private Secretary

19 December 1988

Distribution

HM Treasury
Those present

Inland Revenue
Mr Battishill
Mr Isaac
Mr Beighton
Mr Painter
Mr Corlett - Item 1 (only)
Mr Kuczys - Item 1 (only)
Mr Lewis - Item 2 (only)
Mr Cayley - Item 2 (only)
Mr Farmer - Item 2 (only)
Mr Johns - Item 3 (only)
Mr Nield - Item 3 (only)
Mr Fawcett - Item 3 (only)

CONFIDENTIAL

Inland Revenue

International Division
Somerset House

FROM: P W FAWCETT
20 DECEMBER 1988

PS/CHANCELLOR (MR TAYLOR)

Ch,
This wasn't discussed explicitly at the meeting. It was the last point in Mr Gilhooly's annotated agenda (behind) meeting papers.
Content?
[initials] 5/1

Content

I refer to Mr Gilhooly's note of 12 December on item 3 (unit trusts) of the Chancellor's meeting at 4.30 pm on 13 December, in particular to the Inland Revenue recommendation of applying IT/CGT on investors switching investments in umbrella funds offshore, in the same way as they are applied to investors in onshore funds. I believe that FP are content with this recommendation. Can I take it that the Chancellor agrees with this recommendation and that the Inland Revenue can now instruct Parliamentary Counsel to draft a provision for the Finance Bill accordingly?

PWF

P W FAWCETT

---

cc.	Chancellor of the Exchequer	Chairman
	Financial Secretary	Mr Isaac
	Economic Secretary	Mr Beighton
	Sir P Middleton	Mr Houghton
	Mr Scholar	Mr Johns
	Mr Culpin	Mr Nield
	Mr Odling-Smee	Mr Fawcett
	Mr Gilhooly	PS/IR
	Mr Ilett	
	Mr Matthews	
	Mr MacPherson	
	Mr Neilson	
	Mrs Chaplin	
	Mr Tyrie	
	Mr Call	

MINUTES OF A MEETING HELD IN THE CHANCELLOR'S ROOM HM TREASURY AT 4.30 PM ON TUESDAY, 20 DECEMBER

Present: Chancellor of the Exchequer
Financial Secretary
Mr Scholar
Mr Culpin
Mr Ilett
Mr S Matthews
Miss Hay
Mr Sharples
Mrs Chaplin

Mr Battishill - IR
Mr Beighton - IR
Mr Deacon - IR
Mr Haigh - IR
Mr Newstead - IR

Mr Jenkins (OPC)

....

LIFE ASSURANCE

Papers: Mr Haigh's note of 20 December, Mr Deacon's note of 19 December; PS/Chancellor's note of 19 December; PS/Financial Secretary's note of 15 December; Mr Beighton's and Mr Deacon's notes of 8 December; PS/Chancellor's note of 5 December.

The Chancellor, opening the discussion, said that there were two front runners for the taxation of acquisition expenses. First, the Financial Secretary's option which allowed relief over 7 years against realised gains, and which charged both income and gains at 25 per cent. Second, his preferred option, which was similar but did not involve spreading over 7 years unless there were inadequate gains in any one year. It had been suggested that his option would give rise to behavioural effects. But the incidence of these could be exaggerated.

2. Continuing, the Chancellor said the essential question was whether either option should be pursued. The logic of taxing acquisition expenses needed to be analysed. Although the life companies' initial costs could be described as acquisition costs, they were nothing like the costs incurred by an individual in the acquisition in shares. Even if the argument could be made to run, it was clear that under either option there would be a very big increase in the burden of tax on the industry as a whole. This could be difficult to defend.

3. Mr Beighton said that the position of the life assurance industry was unique. Hence, its tax treatment must be unique. We could not do what the ABI wanted, which was to treat the industry as unique in those respects which allowed it a more favourable tax treatment, but to treat it as equivalent to other industries in the areas where this did not occur. He noted that no other type of business had an equivalent basis of taxation to I-E. The Chancellor said that there might well be some rough justice in the options. But more than this would be needed to justify the very large increase in the tax base. This was particularly so in a budget which would otherwise be seeking to encourage savings.

4. Continuing, the Chancellor said that it was hard to find a comparator against which the industry could be presented as being lightly taxed. Acquisition expenses were a legitimate expense. It could be argued that the present regime encouraged the companies to run a high cost, front end operation. But this was not sufficient to justify the additional weight of tax implied by either option.

5. Mr Scholar said that, in his view, the rationale for reforming the tax treatment of acquisition expenses was soundly based. But it would be difficult to persuade the world of that,

particularly if the reform brought in a large additional yield. Why not, initially at least, lower the rate of Corporation Tax from 25 per cent? The Chancellor said he would prefer to keep the 25 per cent rate. This matched the action being taken elsewhere, and appeared less arbitrary. If some phasing were required, he would prefer to implement this by relieving only, say, half the acquisition expenses at the outset. Mr Battishill said it was important that Ministers should be comfortable with the rationale for any changes. Once this had been settled, then the details of any easing of the burden could be discussed. But these two questions should be treated separately. The Financial Secretary said he was content with the rationale. As far as relief was concerned, he would prefer a lower tax rate to eg partially relieving expenses.

6. The Chancellor asked about the breakdown of the additional yield. Mr Haigh said that, without the acquisition cost package, the yield would be £200-250 million. If no action were taken on acquisition costs, there could be a significant yield from action on captive Unit Trusts, though it was not possible to give an order of magnitude to this at this stage. The cost of reducing the tax on capital gains only to 25 per cent would be modest.

7. The Chancellor said he was minded to limit action in 1989 to ring-fencing life offices' pensions business, and making other changes to their pensions treatment; abolishing Stamp Duty; and reducing the tax on their capital gains to 25 per cent. Acquisition costs would be for further consultation. The rationale for acquisition expenses did need further examination. The Chancellor noted that, in these circumstances, it would be necessary to take action to stop the loophole created by taxing unit trusts at 25 per cent. He asked the Revenue to provide a paper on this.

8. Mr Culpin said that, if Ministers could agree with the rationale, 1989 would be a particularly good year for implementing the change to the taxation of acquisition expenses. First, it would avoid a further year during which opposition would build up. Second, it would fit well into the proposals for evening out the tax treatment of direct and indirect savings vehicles. The Chancellor said that, against this, it would be hard to defend a change without taking further steps than currently envisaged to alter the tax treatment of pensions; when we would in any event wish to pursue the "tidying up" measures listed in paragraph 7 (above) for the taxation of life assurance, and when the industry would also be facing considerably increased non-tax burdens from the SIB. More generally, there was no great merit in structural change for its own sake. Changes could be justified only by the need to create a level playing field.

9. Sir Peter Middleton said that he could only just believe in the rationale for changing the taxation of acquisition expenses. It would be very difficult to use this rationale as a public justification for making these changes. He was therefore strongly inclined to limit any changes in 1989 to the "tidying-up" measures suggested by the Chancellor, and to leave the remainder for subsequent consultation.

10. The Chancellor, summing up, said that the presumption should be that action in 1989 was limited to the steps suggested in paragraph 7 above. Other action - including changes to the taxation of acquisition expenses - should be for further consideration. He invited:

- Mr Scholar to provide early advice to the Financial Secretary if he thought there was a case for any further action in 1989;

Inland Revenue to provide submissions to the Financial Secretary on the possibilities for (i) canvassing future changes to acquisition expenses in a consultative document, with a view to action in 1990; and (ii) on phasing-in the changes starting in 1989. He also asked for a paper (paragraph 7 above) in the read-across to what has envisaged for unit trusts.

ACSA

pp **J M G TAYLOR**
21 December 1988

Distribution

Those present
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary

Inland Revenue

Oil and Financial Division
Somerset House

FROM: A J BOLTON
DATE: 21 DECEMBER 1988

FINANCIAL SECRETARY

UNIT TRUSTS
LETTER FROM FRANCIS MAUDE

1. Mr Maude's letter asks you to give an immediate signal to the unit trusts that the Government acknowledges them to suffer tax disadvantages "to which solutions need to be found". He fears that many unit trust groups may not wait for the Budget before deciding to migrate to Luxembourg for tax reasons.

2. The Financial Services Act regime for foreign collective investment schemes is being implemented on 31 December 1988. DTI see no option but to grant Luxembourg interim UCITS recognition very shortly thereafter, many months in advance of general UCITS implementation on 1 October 1989. Luxembourg based schemes would then be freely marketable in the UK on the same terms as domestic authorised unit trusts. Unless you reassure UK funds about tax, the argument goes, many may migrate to Luxembourg immediately "as professed tax exiles".

3. The Unit Trust Association has told us that action in the Budget should be soon enough to prevent a serious exodus. Indeed they went so far as to say that a declaration of Government intent at Budget time would probably be sufficient even if it were not possible to bring forward legislative proposals in 1989.

4. An early announcement about unit trusts would probably alarm their competitors (Investment Trusts, Life Assurance) prematurely. It is unlikely that we would have draft clauses available much before Budget time even if you were minded to publish them.

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cc PS/Chancellor
Mr Gilhooly
Miss Hay
Mrs Chaplin
Mr Ilett
Mr Johns
Mr J F Hall
Mr Nield
Mr Fawcett
Mr McCarney
PS/IR

014.txt

5. The unit trusts well know that Ministers are considering their representations, and we are in close touch with them at official level. We do not think that any more explicit signals are necessary or desirable prior to the Budget.

6. We offer the attached draft reply.

A Britt

A BOLTON

014.txt

Susan 3.22.12.88

CC: PS/Chancellor
Mr Gilhooly, Miss Hay,
Mrs Chaplin,
Mr A J. Bolton - IR,
PS/IR.

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

Hon Francis Maude MP
Parliamentary Under Secretary of State
for Corporate Affairs
Department of the Trade and Industry
1-19 Victoria Street
London SW1H 0ET

30 December 1988

Dear Francis

Thank you for your letter of 30 November 1988 about the timing of regulatory changes and possible tax changes affecting unit trusts. You are concerned that the effective early implementation of the UCITS directive allowing Luxemburg-based funds to be marketed freely in the United Kingdom may cause UK firms to migrate to Luxemburg immediately unless they have some public assurance that the Government acknowledges a need to change the UK tax regime for units trusts.

We are, of course, considering the Unit Trust Association's proposals in detail. I met representatives of the Association in October and they have continued to keep in close touch with Inland Revenue Officials. However,as you recognise, attaining UTAs objectives raises a number of difficult tax issues, not least concerning competition in the UK between authorised unit trusts, other investment media and direct investment.

Should we decide to bring forward tax changes for unit trusts I am not clear that it would be necessary or desirable to make any kind of special announcement in advance of the Budget. As I understand them, UTA would regard a Budget Day announcement as soon enough to prevent a serious tax driven exodus of unit trusts. In any case, I should have thought that the contacts with the unit trust movement, both at Ministerial and official level, ought to be sufficient to signal the seriousness with which we are treating this issue.

We do recognise the importance of these matters, and your detailed explanation of the regulatory run up to the UCITS directive are most helpful. However, my conclusion is that the Budget and Finance Bill process should take its normal course.

I am sending a copy of this to Lynda Chalker.

Yours ~

Norman

NORMAN LAMONT

chex.md/jmt/11 CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 6 January 1989

MR FAWCETT IR

cc PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mr Matthews
Mr MacPherson
Mr Neilson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill IR
Mr Isaac IR
Mr Beighton IR
Mr Houghton IR
Mr Johns IR
Mr Nield IR
PS/IR

UNIT TRUSTS: UMBRELLA FUNDS

The Chancellor has seen your note of 20 December.

2. He agrees with the Inland Revenue's recommendation of applying IT/CGT on investors switching investments in umbrella funds offshore, in the same way as they are applied to investors in onshore funds. You can instruct Parliamentary Counsel to draft a provision for the Finance Bill accordingly.

J M G TAYLOR

Inland Revenue

Oil and Financial Division
Somerset House

From: A G Nield
Tel: 6412
Date: 6 Jan 1989

1. MR JOHNS MAJ 6/1
2. FINANCIAL SECRETARY

UNIT TRUSTS

1. This paper responds to the Chancellor's request for a note about the implications for corporate investors of taxing certain unit trusts at 25% (para 7 of the minutes of the Chancellor's meeting on 20 December).

The problem

2. A corporate investor in sources of income other than UK dividends could avoid the difference between his mainstream CT rate of 35% and the lower rate of 25% to be applied to unit trusts, by investing via a unit trust rather than directly. This is because distributions from unit trusts are franked investment income and, as such, are not liable to any further tax in the hands of the corporate investor. An example is set out in Annex A. The effect would be a substantial cost to the Exchequer, building up over time, and distortion of companies investment patterns, encouraging them to invest via unit trusts rather than direct.

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cc PS Chancellor
Sir Peter Middleton
Mr Scholar
Mr Culpin
Mr Odling Smee
Mr Ilett
Mr Neilson
Mr Gilhooley
Mrs Chaplin
Mr Tyrie
Mr Jenkins (Parliamentary Counsel)
Mr Beighton
Mr Houghton
Mr Corlett
Mr Pitts
Mr Johns
Mr McGivern
Mr Deacon
Mr Nield
Mr Reed
Mr Haigh
Mr Bolton
Mr Cleave
PS/IR

The solution

3. The solution is to impose a tax charge on corporate investors, on income they receive from a unit trust, to make up for the difference. This can be done by deeming distributions from unit trusts to corporate investors to be annual payments, from which tax has been deducted at source. It would ensure that the corporate investor pays CT on the annual payment at 35%, but gets credit only for tax at the 25% actually paid by the unit trust.

4. The solution would, however, penalise distributions derived from income which the unit trust itself has received as franked investment income. It would require a corporate investor to pay an additional 10% mainstream CT on income that had already normally borne mainstream CT before it came into the hands of the trust. Annex B illustrates how this arises. Life companies are the main corporate investors in unit trusts and, if their rate of tax were reduced to 25%, the penalty would not bite on them. But if action has to be taken to remove the penalty, it would be necessary to regard distributions as partly franked investment income, to the extent that they are derived from such income, and partly annual payments, to the extent that they are derived from other income sources.

5. In order to achieve this, unit trusts would have to supply a certificate showing how the split between the two sorts of income. The charge on corporate investors would then be limited to the proportion of the distribution not derived from franked investment income. This adds to the complexity of the scheme for us, for the trusts, and for corporate unit holders. It would add up to a page to the legislation. However we believe the complexities would be manageable for the unit trusts and would not add significantly to our staff costs.

Read across from life assurance

5. The main corporate investors in unit trusts are life assurance companies. They invest in trusts marketed to the public and they also have captive unit trusts which serve as dedicated investment vehicles for particular life companies. Their investment in unit trusts is thought to amount to around one half of the total investment in unit trusts. They would be the bodies mainly affected by the penalty discussed in para 4 above, if all amounts distributed to corporate unit holders were treated as annual payments.

6. The penalty would disappear for life companies if their rate of mainstream corporation tax were reduced to 25%, since in that case no mainstream CT would be due from the company over and above the tax already deducted at source even if the distribution was treated as unfranked income. There would be no need, at least so far as life companies are concerned, for unit trusts to provide certificates showing the split of distributions between different sorts of income. This would clearly result in a much simpler scheme for both the Revenue and the unit trusts themselves.

7. There would of course remain the theoretical possibility of a penalty on other corporate investors, but we think they are few in number and generally do not hold large amounts of units. Clubs and small associations are the most likely holders, but they will generally benefit from the small companies rate of CT, which would remove any penalty for them, in the same way as a 25% rate for life companies.

8. We cannot be absolutely certain that there would be no complaints from corporate investors other than life companies, but we think Ministers' starting point could reasonably be that no special arrangements are needed for such investors, if the life assurance company rate is set at 25%. There is also a general point, that the tax advantages of unit trusts were not intended for corporate investors. Whilst the weight of investment that life companies have already put into unit

trusts cannot be ignored, there is no reason why investment by other corporates should be encouraged or particularly catered for.

9. Reduction in the life companies' CT rate would, of course, remove the advantage they would otherwise gain from investing in unit trusts paying only 25% CT. But this does not remove the need for the anti-avoidance charge. Without it, other corporate investors could be encouraged to move into unit trusts. There could well be new forms of unit trusts developed, directed at the corporate investor. And we might see captive unit trusts developing outside the life industry.

Conclusions

10. The avoidance possibilities must be dealt with. Otherwise corporate investors would have an incentive to transfer unfranked investment income (primarily bond income) into unit trusts. A charge on corporate investors is needed to counter the avoidance. But the avoidance does not arise in respect of franked income, which would be penalised by the proposed charge. The penalty mainly affects life companies, and would be removed for them in any case if their rate of corporation tax were reduced to 25%. For others, the penalty is unlikely to arise in practice. If the life rate were reduced, we would therefore advise Ministers to do nothing more than include a provision taxing distributions to corporate unit holders as annual payments. Relief could be introduced at Committee Stage if a substantial number of companies advance good reasons why they should invest in unit trusts. If the life assurance rate is not reduced, we think it would be necessary to limit the charge to income derived from sources other than franked investment income, with the complexity this will entail, for the industry in giving certificates, for corporate investors in preparing their tax calculations, and for us in checking them. This would be in order to avoid a very significant penalty for the large existing investment by life companies in unit trusts.

11. Ministers are invited to endorse these conclusions, and agree that

- distributions to corporate investors should be taxed in their hands as though they were annual payments from which tax at the basic rate of income tax has been deducted at source;

- if the life assurance rate is not reduced to 25%, only distributions derived from unfranked income should be so taxed;

- if the life assurance rate is reduced to 25%, all distributions should be so taxed, in order to avoid the complexities of having to split distributions between different types of income.

12. Although a reduction in the life assurance rate would enable a simpler regime to be devised for unit trusts, the issues discussed in this note are not sufficiently significant to sway that decision except at the margin.

Geoff Nield

GEOFF NIELD

ANNEX A

Example showing effect of corporate investor receiving untaxed income via a unit trust, if unit trust taxed at 25% and distribution is franked investment income, compared with direct investment.

Investment in Eurobond yielding £1000 gross income.

	Direct investment by corporate investor	Investment via unit trust
gross income recd by UT	-	1000
Tax paid by UT		250
Received by corporate investor	1000	750
Tax paid by corporate investor	350	nil
Available for distribution by corporate investor to his shareholders	650	750

ANNEX B

Example showing position of distributions to corporate investors where distribution derived from franked investment income

(a) under present regime for authorised unit trusts; and

(b) showing effect of treating distribution as an annual payment from which tax has been deducted at basic rate of income tax.

	(a) Present regime	(b) distribution as annual payment
Net dividend received by UT	750	750
Tax payable by Unit Trust	Nil (franked by tax credit on dividend)	Nil (franked by tax credit on dividend)
Net distribution to corporate unit holder	750	750
Tax payable by corporate unit holder (on 1000 gross income)	Nil (franked by tax credit accompanying distribution from unit trust)	100 (350 mainstream CT less 250 credit at basic rate of income tax)
Available for distribution by corporate investor to his shareholders	750	650

24 JAN 1989

dti

the department for Enterprise

The Hon. Francis Maude MP
Parliamentary Under Secretary of State for
Corporate Affairs

The Rt Hon Norman Lamont MP
Financial Secretary
HM Treasury
Treasury Chambers
Parliament Street
LONDON SW1P 3AG

Department of
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FINANCIAL SECRETARY
REC. 24 JAN 1989
ACTION Mr A Bolton -IR
COPIES TO PS/Chancellor
Mr Ilett, Mr Gilhooly,
Miss Hay
MB Chaplin, PS/IR.

Direct line 215 4417
Our ref
Your ref
Date 23 January 1989

Dear Norman,

Thank you for your reassuring letter of 30 December about possible tax changes affecting unit trusts. I quite understand the difficulties in the way of making any announcement before the Budget, and in the circumstances - particularly that there has been no indication, since I wrote, of any increased tendency towards emigration and that the Budget is now only a few weeks away - I am content to leave things on the basis of your letter.

Francis.

FRANCIS MAUDE

JCGATP

the Enterprise initiative

BUDGET CONFIDENTIAL

Inland Revenue

Oil and Financial Division
Somerset House

Now that it is clear that there will be a gap between the start of the new unit trust regime and the start of the life assurance regime, I think we have to go for the complexities of ratification. The alternative of penalising life companies during the transition would risk sinking the whole package.

FROM: A G NIELD

DATE: 23 JANUARY 1989

1. MR JOHNS MJ 23/1

2. FINANCIAL SECRETARY

I was holding back the earlier note until he had had a chance to comment. He now plans a meeting later this week.

UNIT TRUSTS

1. My note of 6 January discussed the implications for corporate investors in unit trusts of a reduction in the unit trust rate to 25%. This note draws attention to a further point that has arisen. Paras 2 to 6 below summarise my earlier conclusions. The remainder of this note explains how the new point affects them.

---

cc PS Chancellor
Sir Peter Middleton
Mr Scholar
Mr Culpin
Mr Odling Smee
Mr Ilett
Mr Neilson
Mr Gilhooley
Mrs Chaplin
Mr Tyrie
Mr Jenkins (OPC)

Mr Beighton
Mr Houghton
Mr Corlett
Mr Pitts
Mr Johns
Mr McGivern
Mr Deacon
Mr Nield
Mr Reed
Mr Haigh
Mr Williams
Mr Cleave
PS/Registry

Position as in note of 6 January

2. The problem to which I drew attention was that a corporate investor, liable to corporation tax at 35%, could "wash" unfranked income by channelling it through a unit trust, where it would bear tax at only 25%.

3. The solution proposed was to treat income emerging from a unit trust as unfranked income - i.e. as an annual payment from which tax has been deducted at source.

4. This would solve the problem for income which the unit trust receives as unfranked income, but it would impose a penalty on corporate investors where the trust's source income is franked investment income. They would pay tax at 35%, and get credit for only 25%. To prevent the imposition of this penalty, we would (subject to what is said in the following paragraph) have to provide for unit trusts to certify the nature of their source income, and only treat income emerging from a trust as unfranked income to the extent that the trust's income was itself certified to be unfranked.

5. In practice, life assurance companies are the main corporate investors affected by the penalty. If their rate of corporation tax were reduced to 25%, the penalty would disappear anyway, because their rate of tax would be the same as the rate at which they would get credit for tax paid by the unit trust. So we would be able to do without the complication of requiring trusts to certify the nature of their source income.

6. All this led us to conclude that

- unit trust distributions to corporate investors should be taxed in the hands of the investor as though they were annual payments from which tax at the basic rate of income tax has been deducted;

- if the life assurance rate is not reduced to 25%, only distributions derived from unfranked income should be so taxed;

- if the life assurance rate is reduced to 25%, all distributions should be so taxed, in order to avoid the complexities of having to split distributions between different types of income.

<u>The new point</u>

7. It is likely that, even if the rate of tax for life assurance companies is reduced to 25%, the effective date for the reduction will be 1 January 1990 at the earliest. If the unit trust changes are introduced from 1 April 1989 as intended, there will be a transitional period of at least nine months during which life companies are certain to be penalised, unless we make unit trusts certify the nature of their source income and restrict the treatment as annual payments to the part of distributions derived from unfranked income.

8. In this scenario, there are the following (theoretical) possibilities:

(a) allow the penalty to fall on life companies during the transitional period (and perhaps attempt to justify it by pointing to the benefits for them in the life assurance package);

(b) provide a certification process, in effect to deal primarily with the transitional period; and

(c) change the start date for the reduction in the unit trust rate to align it with the timing of the change in the life assurance rate.

9. We do not recommend (a). Although it might be possible to run the argument that life companies would generally be getting more than commensurate benefits under the life assurance package, the incidence of penalties and benefits are likely to be uneven as been different companies, and some types of policy holder (e.g. of a unit linked policy) could be hit by the penalty even though overall there is a negligible effect on the company. Moreover, it would be apparent that the penalty arises from a rough edge in the unit trust changes, intended generally to be beneficial, rather than a measured trade off within the life assurance package.

10. Nor do we recommend (c). We would have to wait for firm decisions on life assurance before we could settle on starting arrangements for unit trusts. And we think Ministers would find it unattractive to ask the unit trust industry to wait for a scheme that is already somewhat less than the Unit Trust Association were seeking.

11. This leaves (b) - the certification route. We would have liked to avoid this if possible, but we think it is preferable to either the imposition of penalties on life companies or a delay in the starting date. And although we would be providing for certification primarily to deal with the transitional problem for life companies, it would have the incidental advantage of getting the unit trust regime right for all corporate investors. It would avoid any possibility of complaints of the kind mentioned in para 8 of my note of 6 January. It would be possible to take powers to switch off the certification requirement by regulation (subject to affirmative resolution) if, following the reduction in life assurance rates, it were no longer considered necessary.

12. We therefore recommend the option at para 8(c).

13. If this conclusion is agreed, it means that we shall proceed on the basis that (whatever happens to the life assurance rate) unit trust distributions to corporate investors should be taxed in the hands of the investor as though they were annual payments from which tax at the basic rate of income tax has been deducted, but only to the extent that they are derived from unfranked income.

I should be grateful for your confirmation that this is acceptable to Ministers.

GEOFF NIELD

fim2.cd/ilett/min82

BUDGET CONFIDENTIAL
Covering Unclassified

FROM: N J ILETT
DATE: 26 JANUARY 1989

FINANCIAL SECRETARY

cc PS/Chancellor
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Odling-Smee
Mr Gilhooly
Mr Sharples
Mrs Chaplin

PS/IR
Mr Nield IR

UNIT TRUSTS: LUXEMBOURG PROBLEM

Mr Francis Maude's letter to you of 23 January accepts that you are not prepared to make any promises about the taxation of unit trusts under the new UCITS regime before the Budget. You will recall Mr Maude's request last year that you forestall the anticipated departure of the UK unit trust industry to Luxembourg by promising them a good Budget. As Mr Maude admits, this exodus has not yet materialised.

2. Mr Maude's letter provides a useful peg on which to draw to his attention that the DTI is still maintaining an unnecessary regulatory restriction on the unit trusts industry, namely that collective investment through open-ended investment companies continues to be banned on the UK mainland. The work we and the Revenue have done on the "Luxembourg" problem has shown that it is not just tax differences which may make UK-based unit trusts unattractive in the internal market, but also our insistence that our investment management industry must work through unit trusts, under trust law, rather than the open-ended investment companies which are more familiar on the Continent and, indeed, in Japan.

3. The DTI has not so far got round to changing the law, despite the fact that legislation was promised in the 1985 Financial Services White Paper. The clauses were dropped from the Bill because of lack of time and because there was no particular demand from the industry. Such demand has now emerged, as the investment management industry has been forced to address the

issue, but DTI officials say it is too late to do anything in the Companies Bill. I think DTI officials have got their priorities wrong, and it makes sense to hint to Mr Maude that he ought to deal with inadequacies in the regulatory system if he expects you to make changes to the tax system.

4. The Revenue advise that it would of course be necessary to amend the tax regime to provide for open-ended investment companies, which would take space in the 1990 Finance Bill. They also suggest that to allow a new type of UCIT, which would presumably need tax treatment equivalent to that of UCIT unit trusts, would increase the pressure which we are anticipating from non-UCIT unit trusts (commodities etc) who will want to share the budget concessions to UCIT unit trusts. But Mr Nield does not think this should stand in the way of your writing if you accept FIM's advice.

5. I attach a draft letter for that purpose. This could be amended for the Economic Secretary's signature if you and he felt that would be more appropriate, given that the substance is about regulation.

M.

N J ILETT

DRAFT LETTER FROM: FINANCIAL SECRETARY

The Hon Francis Maude MP
Parliamentary Under Secretary of State
for Corporate Affairs
Department of Trade and Industry
1-19 Victoria Street
LONDON SW1

UNIT TRUSTS

Thank you for your letter of 23 January, in which you say you are content to leave our discussion of the tax treatment of unit trusts until the Budget. I am replying on a separate but connected point.

The work we have done in the Treasury and the Inland Revenue on the unit trust industry's arguments for tax changes has shown that there is a significant regulatory impediment which deserves attention. This is that "unit trusts" as such - ie UCITS managed under trust law - are a form of investment which is relatively unknown outside the UK. ~~and~~ So there is some concern in the investment management industry that it will be difficult to sell them in other countries within the Community, and, indeed outside - for example in Japan.

I understand that there is no reason in principle why we should not change UK laws to allow open-ended collective investment companies on the Continental pattern. Indeed a commitment to change the law was given in the 1985 Financial Services White Paper. It seems pointless to force UK companies who see advantage in developing collective investments in this form to go to the Channel Islands or Luxembourg, as they are doing. Irrespective of what may or may not be done on the tax front, on which I know you will not expect me to comment at this time of year, it would make sense to remove this unnecessary regulatory obstacle immediately. The Companies Bill provides an opportunity which may not be available again before it is too late.

NORMAN LAMONT

BUDGET CONFIDENTIAL

Inland Revenue

Oil and Financial Division
Somerset House

FROM M A JOHNS
DATE 27 JANUARY 1989

FINANCIAL SECRETARY

UNIT TRUSTS: LUXEMBOURG PROBLEM

I should perhaps comment in a little more detail on the reference to tax in Mr Ilett's note of 26 January. As Mr Nield explained (paras 56-74 of his note 9 December) there are problems about extending the proposals for unit trusts which are also UCITS to other vehicles which we shall need to review after this year's Budget. There will be immediate pressure from Budget Day for extension or the provision of other similar benefits to many other sorts of vehicle including investment trusts (of which the open-ended vehicle will be a sub-class). You will want to say that the immediate pressure is for UCITS and that you will look more widely at other types of collective investment media over the ensuing year. At this stage there can be no certainty on what this review will eventually propose.

In these circumstances it will make your position more difficult if DTI have legislated to permit a vehicle that is a UCITS but is not a unit trust. You may come under pressure to include these in your 1989 legislation but there will also be greater pressure on the deductibility of interest since investment trusts have traditionally borrowed much more than unit trusts. Your position would be easier in Finance Bill debates if the regulatory change could be deferred until after they are finished.

cc PS/Chancellor
PS/Economic Secretary
Sir Peter Middleton
Mr Scholar
Mr Odling Smee
Mr Gilhooly
Mr Sharples
Mr Chaplin
Mr Beighton
Mr Johns
Mr Bush
Mr Nield
Mr Hall
PS/IR

I understand, however, that if the DTI miss the opportunity provided by the current Companies Bill it is uncertain when another opportunity will occur. It was for this reason that we agreed that the tax problem should not stand in the way of your writing. But if you do so you need to be aware that it may not be totally straightforward in policy terms either to extend the unit trust proposals to all investment trusts or to open-ended trusts. And you may like to consider whether it would be better to encourage DTI to take powers to permit the formation of such companies (and delay approving them for the time being) rather than encourage the taking of powers to set them up in advance of a full review of the tax rules for unit and investment trusts outside UCITS during 1989/90. If so, you might like to change the end of Mr Ilett's draft letter to something like:

"It seems pointless to force UK companies who see advantage in developing collective investments in this form to go to the Channel Islands or Luxembourg, as they are doing. The tax treatment would, of course, need to be reviewed and I know you will not expect me to comment at this time of year on this. But it would make sense immediately to take powers to remove this unnecessary regulatory obstacle, powers which would be exercised once the tax position has been reviewed. The Companies Bill provides an opportunity which may not be available again before it is too late."

M.A. Johns

M A JOHNS

chex.rm/jmt/80

BUDGET CONFIDENTIAL
AND PERSONAL

FROM: J M G TAYLOR
DATE: 27 January 1989

PS/FINANCIAL SECRETARY

[Also asked RPC to look at]

UNIT TRUSTS

The Chancellor has seen the Financial Secretary's note of 26 January.

2. He wonders whether the Financial Secretary might not reconsider his decision on which option to follow. Would it not be very much simpler to go for option 8(c) - as (no doubt inadvertently) recommended in Mr Neild's paragraph 12 - and defer the reduction in the Unit Trust rate to 1 January, in line with the insurance company change?

3. The Chancellor recognises, of course, that if we decide <u>not</u> to do the insurance company change we would be forced to option 8(b); but he trusts this will not happen.

J M G TAYLOR

Robert 02.26.1.89

BUDGET CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: R C M SATCHWELL

DATE: 26 January 1989

MR NIELD - IR

cc PS/Chancellor
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mr Sharples
Mrs Chaplin
Mr Tyrie
Mr Jenkins-OPC

Mr Johns - IR
PS/IR

PS: (8(b)) for attention [illegible] RPC's view, see note.

Ch/ OK?

[illegible] 26/1

UNIT TRUSTS

The Financial Secretary discussed your minutes of 6 and 23 January with you and others. He agrees with your recommended option in para 8(b) of your minute of 23 January; namely that because of the transitional period before the corporation tax rate for life assurance companies is reduced to 25%, there should be a certification process for unit trusts identifying the nature of their source income. Distributions to corporate investors will be taxed in the hands of the investor as annual payments from which basic income tax has been deducted; though only to the extent that they are derived from unfranked investment income.

Pse ask FST (privately) if unconvinced - wouldn't it be very much simpler to go for option 8(c) - no doubt substantial [illegible] Mr N's comments - and defer the para 12 reduction in the Unit Trust rate to 1 Jan, in line with the Ins. Co change? I recognise, of course, [illegible] but I think [illegible] to do [illegible] no Ins. Co. change

R.C.M.S.

R C M SATCHWELL
Private Secretary

[illegible] 8(5): I [illegible] this would happen

Inland Revenue

Capital and
Valuation Division
Somerset House

FROM: M F CAYLEY
DATE: 21 February 1989

1. MR PITTS 21/2
2. MR PAINTER 21.2.
3. FINANCIAL SECRETARY

CGT: UNIT AND INVESTMENT TRUST SAVINGS SCHEMES

1. Last year you authorised us to enter into discussions with the Unit Trust Association to see if we could find a way of simplifying CGT computations for investors in monthly savings schemes. We broadened these discussions to include the Association of Investment Trusts, as many investment trusts now run similar schemes. We have reached agreement on a Statement of Practice, and this minute seeks your approval of its issue.

2. The Statement looks complicated, but in fact the complications arise only for a minority of investors whose circumstances are relatively unusual. For the straightforward investor who is investing regularly and making no withdrawals (or only small withdrawals), only one stage of CGT computation will be needed for each full year of saving: he will be treated as having made annual investments equal to his total net savings in each year. This contrasts with the present position

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cc. Chancellor
Chief Secretary
Paymaster General
Economic Secretary
Mr Culpin
Mrs Chaplin
Mr Tyrie
Mr Painter
Mr Pitts
Mr Hamilton
Mr Cayley
Mr Beauchamp
Ms McFarlane
Mr Sawyer
PS/IR

where twelve stages of computation are required, one for each month. So for most savers the Statement will cut out eleven-twelfths of the burden of CGT computations. The precise scheme we have agreed does not put the Exchequer at any significant risk: if anything, it will <u>very</u> <u>marginally</u> cut down the taxpayer's indexation allowance. A taxpayer who is not prepared to accept this can of course opt for the full statutory basis of computation.

3. We would like to issue the Statement before the start of the 1989 tax return season, so that taxpayers can use its approach in completing their tax returns for 1988-89. One option would be to issue it on Budget Day, but practitioners might then lose sight of the Statement in their concentration on other changes. We would therefore advocate issue on a different day. Our preference would be to publish the Statement before Budget Day, as its existence then has more chance of being registered by accountants etc before they start helping taxpayers with their tax returns. As the subject should be non-controversial and the content of the Statement is relatively mechanical, the usual reason for hesitating over making public statements in the run-up to Budget Day would seem not to apply. But if Ministers see difficulties, we would suggest issue early in the week after Budget Day (beginning 20 March).

4. I would be grateful to know if you are content with the attached Press Release and Statement of Practice. If so, would you be content for us to issue it before Budget Day or would you prefer publication to be around 20 March?

Michael Cayley

M F CAYLEY

pitts.mss

INLAND REVENUE

Press Release

INLAND REVENUE PRESS OFFICE, SOMERSET HOUSE, STRAND, LONDON WC2R 1LB
PHONE: 01–438 6692 OR 6706

[3x]

CAPITAL GAINS TAX: MONTHLY SAVINGS SCHEMES IN UNIT AND INVESTMENT TRUSTS

The Inland Revenue have today published a Statement of Practice which lets investors in unit and investment trust monthly savings schemes opt for a new simpler basis for computing their Capital Gains Tax liability. It can be used by anyone disposing of investments on or after 6 April 1988.

Simplified computations will save most investors a considerable amount of effort particularly in working out their Capital Gains Tax indexation allowance. It will commonly cut out eleven-twelfths of the calculation otherwise necessary. Investors applying to their tax office to use the new arrangement will no longer have to do a separate stage of calculation for each month of saving. Instead, in most cases they will be treated as having made a single annual investment in the seventh month of the trusts' accounting year. This will be made up of savings plus re-invested income less any small withdrawal in the year.

/STATEMENT OF PRACTICE

Statement of Practice

SP /

Date

INLAND REVENUE,SOMERSET HOUSE,LONDON

FURTHER COPIES OF THIS STATEMENT MAY BE OBTAINED BY WRITING TO (PLEASE ENCLOSE A STAMPED ADDRESSED ENVELOPE) OR BY CALLING PERSONALLY AT THE PUBLIC ENQUIRY ROOM ,WEST WING SOMERSET HOUSE, STRAND, LONDON WC2R 1LB

UNIT TRUST AND INVESTMENT TRUST MONTHLY SAVINGS SCHEMES

INTRODUCTION

1. This Statement of Practice sets out the circumstances in which the Inland Revenue will be prepared to accept simplified capital gains tax computations from individuals investing regular sums in monthly savings schemes of Authorised Unit Trusts and Approved Investment Trusts. Where taxpayers ask for the Statement to apply, the number of calculations needed to determine capital gains liabilities - and in particular the amount of indexation relief available - will be very substantially reduced. This Statement in no way affects the rights of those who wish to submit computations on the normal statutory basis.

2. Although the Statement has to provide rules for a wide variety of circumstances, its basic approach is simple. Where an investor saves a fixed sum each month and makes no withdrawals, or only relatively small withdrawals, his monthly investments in the fund's accounting year will be added together, with any distributions or allocations of income reinvested in the accounting year, any small withdrawals in that year will be deducted, and the resulting figure will be treated for capital gains tax as if it were a single investment made on the date the seventh monthly investment is made. Suppose, for example, an investor in a unit trust with no net income is saving £50 on the seventh of each month, and the unit trust has an accounting year ending on 31 December. Capital gains tax computations will be done on the basis that the taxpayer had made a single investment of £600 on 7 July. As a result, only one computation will be needed for investments in that year, instead of twelve.

Who can ask for this Statement of Practice to apply?

3. Individuals can ask for this Statement of Practice to apply where they have entered into a monthly savings scheme to invest regular monthly sums in a unit or investment trust and dispose of investments on or after 6 April 1988.

pitts.mss

THIS STATEMENT HAS NO BINDING FORCE AND DOES NOT AFFECT A TAXPAYER'S RIGHTS OF APPEAL ON POINTS CONCERNING HIS LIABILITY TO TAX

How should the taxpayer make the request?

4. Taxpayers must write to their Tax Office within two years of the end of the first year of assessment beginning on or after 6 April 1988 in which

(a) they dispose of units or shares acquired via the monthly savings scheme, and

(b) (i) the resulting gains, together with any other gains made in the year, exceed the capital gains annual exemption for that year or

(ii) the disposal proceeds together with the proceeds of other disposals exceed twice the annual exemption or

(iii) the other disposals in the year give rise to net losses.

5. Where a taxpayer has monthly savings schemes in more than one unit or investment trust, applications for this Statement to apply should be made separately for each trust. Where a taxpayer has more than one monthly savings scheme in the same trust, the application will cover all the schemes concerned, and this Statement will apply as if they formed a single monthly savings scheme.

6. Some savings schemes allow an investor to make a single monthly payment which is split in agreed proportions between different trusts. Where an investor does this, the Statement will apply as if there were separate savings schemes for each trust. Thus an investor who saves £200 a month, with £100 allocated to XYZ Growth Unit Trust and £100 to XYZ Income Unit Trust, will be treated as having two separate savings schemes for £100 a month each.

7. Some savings schemes allow investors to vary from time to time the fund in which their monthly contributions are invested. For example, contributions in months 1 to 8 may be invested in XYZ gilt and bond unit trust, and those from month 9 onward in XYZ equity unit trust. Where this happens, the investor will be regarded for the purposes of this Statement as having ceased contributing under one savings scheme and having started a new scheme.

What will the simplified computation apply to?

8. The simplified rules described below will apply in calculating the gain on the disposal of units or shares in the year of assessment to which the application relates. Where the disposal is a part-disposal, the simplified rules will also apply in determining gains on later disposals of units or shares acquired via the savings scheme, subject to the taxpayer's right to revert to the statutory basis. Apart from special circumstances described later in this Statement, it will not be open to a taxpayer who has reverted to the statutory basis to benefit subsequently for a second time from the simplified rules.

9. Some taxpayers may have both units or shares held within a monthly savings scheme and other units or shares acquired by, for example, separate lump sum investment. This Statement of Practice will apply only to the units or shares held within the monthly savings scheme. Any gain on units or shares acquired in other ways will be computed in accordance with normal capital gains legislation as if those units or shares constituted a holding separate from the monthly savings scheme.

The approach of the simplified computations

10. The general approach is to treat investments and withdrawals in a year during the currency of the savings plan as all made in a single month of the year. The effect is to reduce substantially the number of calculations needed to arrive at capital gains liabilities, and in particular to compute indexation.

11. The year will correspond to the accounting year of the fund. This may not always equate precisely to a calendar period of twelve months, because for some funds the actual date to which accounts are drawn up varies slightly from year to year: for example the accounting date may be set as the second Thursday in November (irrespective of the day of the month on which that day falls), or the day preceding the first or only Contango Day in month A (a Contango Day is the first stock exchange business day after the ending of a Stock Exchange dealing period). Apart from small variations of this kind, special rules will apply when the accounting date is changed: these are described later in this Statement.

12. In the straightforward case where an investor is making regular monthly contributions throughout the accounting year, investments and withdrawals will be treated as made on the day on which the seventh monthly investment in the accounting year is due. The calendar month in which that day falls is referred to later in this Statement as "the seventh month".

13. Where distributions are automatically reinvested, or the savings scheme is being used to acquire accumulation units in a unit trust, the distribution or allocation of income will be treated as invested on the day on which it is credited to the investor, with no adjustment for equalisation. It should be noted that final distributions for an accounting year are credited after the end of that accounting year: even where the final distribution is made at the end of the accounting year, the date it is credited to investors will be the first day of the following accounting year. Accordingly final distributions for an accounting year will, for the purpose of this Statement, be regarded as reinvested in the following accounting year.

EXAMPLE ONE

(a) A new accounting year starts on 1 January.

(b) The taxpayer subscribes £100 a month throughout the accounting year, on the sixth of each month.

(c) The final distribution for the previous accounting year and the interim distribution for the new accounting year total £50 and are automatically reinvested.

In calculating the indexation allowance, the taxpayer will be treated as having made a single investment of £1,250 in July.

EXAMPLE TWO

(a) A new accounting year starts on 20 January and ends on 19 January in the following calendar year.

(b) The taxpayer subscribes £100 a month throughout the accounting year, on the sixth of each month.

(c) The final distribution for the previous accounting year and the interim distribution for the new accounting year total £50 and are automatically reinvested.

The first monthly contribution in the new accounting year is made in February, and the seventh in August. In calculating the indexation allowance, the taxpayer will be treated as having made a single investment of £1,250 in August.

Pre-1982 Holdings

14. For the purpose of calculating capital gains tax and indexation on the statutory basis, pre-1982 holdings (that is units or shares acquired on or before 31 March 1982) are treated as a separate pool from post-1982 holdings (units or shares acquired since 31 March 1982). This will also be the case for the purposes of the special treatment. Indexation will be calculated on two separate pools and any withdrawals will be treated as disposals of units or shares from the post-1982 pool in the first instance, and when that is exhausted, from the pre-1982 pool, in accordance with the existing LIFO (last-in, first-out) rules. This Statement of Practice will not apply to the pre-1982 holding. Where an accounting year straddles 31 March 1982, the Statement of Practice will apply as if regular saving commenced in April 1982, in accordance with the next paragraph: it will not apply to investments and withdrawals up to 31 March 1982.

First year of investment

15. Where an investor commences regular saving part-way through an accounting year, his investments and any withdrawals in that period will be treated as made on the date of the last monthly contribution in the accounting year.

Final year of monthly saving

16. Where regular monthly saving ceases, investments in that period will be treated as made on the date of the last regular contribution or in the seventh month, whichever is the earlier.

One-off extra savings

17. Taxpayers may from time to time make extra payments into their savings scheme in addition to their regular monthly commitment. Provided in any month the extra payment is not more than twice the regular monthly commitment, it will be treated in the same way as the regular monthly savings (and hence, in the normal case, as made in the seventh month). If the extra payment in a month exceeds twice the monthly commitment, it will be treated as made in the actual calendar month in which it occurs.

18. In the case of some investment trusts, arrangements for one-off savings are kept completely separate from the monthly savings schemes. Where this is so, this Statement will not apply to shares acquired by one-off savings.

Increases in Monthly Savings Level

19. Some taxpayers may increase their monthly savings commitment. If the increase occurs after the seventh month, the extra savings will be deemed to be made at the beginning of the following accounting year, and indexation will run from the seventh month for that following year.

EXAMPLE THREE

(a) The accounting year coincides with the calendar year, so that the seventh month is July.

(b) From January to August 1990, the taxpayer saves £50 a month.

(c) From September 1990, the taxpayer saves £100 a month.

(d) The final distribution for 1989 is £50. There is no interim distribution.

The taxpayer will be deemed to have made a single investment of £650 in July 1990. The extra £200 invested between September and December 1990 will be deemed to be invested in January 1991, and added to the investments made in 1991. Indexation will be given on this amount from July 1991.

Withdrawals and Part-disposals

20. Savings schemes allow taxpayers to make withdrawals. Where the withdrawals in any accounting year are less than one quarter of the total regular savings in the accounting year, the withdrawal or withdrawals will not be treated as involving a disposal but the amount invested in the accounting year will be reduced by the amount withdrawn.

21. Where withdrawals exceed one quarter of the total regular savings in the accounting year, this Statement will not apply in relation to savings made in that year: but, provided the necessary conditions are satisfied, the Statement will apply to earlier and later accounting years.

22. Under some investment trust schemes, an investor wishing to realise part of the holding he has built up via the scheme has to make his own independent arrangements to sell the shares (the scheme itself does not offer a facility to dispose of shares). In such cases, this Statement will apply to part-disposals of shares acquired via a savings scheme in the same way as to withdrawals. If at the time of a disposal the investor has shares acquired outside the scheme, the disposal will be treated, so far as possible, as being of those other shares.

Part disposals before 6 April 1988

23. Where there was a part disposal prior to 6 April 1988 and the gain either was assessed or would have fallen to be calculated on the statutory basis under paragraphs 21 and 25 of this Statement had the Statement applied at the time, the simplified rules will apply to investments and withdrawals made from the beginning of the accounting year following the accounting year in which the last such part disposal took place.

Short-term investors

24. This Statement of Practice will not apply to taxpayers who make less than seven months' regular savings under a savings scheme.

Missed Months

25. Some savings schemes allow taxpayers to miss a month of regular saving. This Statement of Practice will apply in the normal way to any accounting year in which the taxpayer misses only one regular monthly payment. If more than one payment is missed in an accounting year the Statement will not operate for investments and withdrawals in that accounting year: but, if the necessary conditions are satisfied it will apply for earlier or later accounting years.

Non-standard periods of account

26. It is possible that a unit or investment trust may occasionally draw up accounts for a period which is less than, or greater than, a year. This will often be the case when a trust first starts operation, and a non-standard period of account will also arise if the accounting date is changed. In these circumstances, special rules will apply:-

(i) if the period of account is less than seven months, investments and withdrawals will be treated as made on the date of the last regular contribution in the period.

(ii) if the period is more than six months and does not exceed twelve months, investments and withdrawals will be treated as made in the seventh month (as defined in paragraph 12).

(iii) if the period exceeds twelve months, it will be subdivided. The first twelve months will be treated as if they formed an accounting year, and investments and withdrawals in them will be treated as made in the seventh month. Investments and withdrawals in the remainder of the period will be treated as made on the date of the last regular contribution in the period.

These special rules will not apply where there is a change of accounting date which is in accordance with a routine formula and which merely reflects a slight variation of the kind referred to in paragraph 11.

Loss of Approved Investment Trust Status

27. Investment trusts have to be approved each year by the Inland Revenue. This Statement will not apply for an accounting year or period for which approval is not obtained. But, provided the necessary conditions are satisfied, it will apply for earlier or later periods for which approval is given.

Interaction with years of assessment

28. An accounting year is unlikely to coincide with a year of assessment. When taxpayers complete their return it may not yet be certain whether all the relevant conditions for the operation of this Statement of Practice will be satisfied for the accounting year straddling the end of the year of assessment concerned. Subject to the following special rules which apply in relation to paragraphs 20 and 21 (treatment of withdrawals):

(a) it should be assumed that monthly savings will continue at the level applying at the end of the year of assessment.

(b) it should be assumed that there will be no withdrawals or one-off extra savings in that part of the straddling accounting year which falls after the year of assessment.

(c) paragraph 20 can only be applied if withdrawals in that part of the straddling accounting year which falls within the year of assessment do not exceed total savings in that part of the straddling accounting year.

If it turns out that the conditions for the scheme to apply are not satisfied in the second part of the straddling accounting year, the treatment of any investments and withdrawals made in the earlier part of the straddling accounting year will not be disturbed.

Robert 1.23.02.89

FINANCIAL SECRETARY TO THE TREASURY

FROM: R C M SATCHWELL

DATE: 23 February 1989

MR CAYLEY - IR

cc 2 PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Culpin
Mrs Chaplin
Mr Tyrie

Mr Painter) IR
Mr Pitts)
PS/IR

CGT: UNIT AND INVESTMENT TRUST SAVINGS SCHEMES

The Financial Secretary was grateful for your minute of 21 February. He is content with the draft Press Release and Statement of Practice. But he would prefer publication to be around 20 March rather than pre-Budget Day.

R.C.M.S.

R C M SATCHWELL
Private Secretary