EXPLANATORY MEMORANDUM TO

THE AUTHORISED INVESTMENT FUNDS (TAX) (AMENDMENT NO. 2) REGULATIONS 2008

2008 No. 1463

1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before the House of Commons by Command of Her Majesty.

This memorandum contains information for the Select Committee on Statutory Instruments.

2. Description

2.1 These Regulations amend the Authorised Investment Funds (Tax) Regulations 2006 (S.I. 2006/964) ("the principal Regulations") by substituting a new regulation 95 of the principal Regulations. Regulation 95 modifies the Finance Act 1996 in its application to authorised investment funds; and the new regulation 95 ensures that Schedule 10 to the Finance Act 1996 applies to open-ended investment companies in the same way as it applies to unit trust schemes and to offshore funds.

3. Matters of special interest to the Select Committee on Statutory Instruments

3.1 None.

4. Legislative Background

4.1 In the Finance (No. 2) Act 2005, Chapter 3 of Part 2 deals with authorised investment funds. There are two major types of authorised investment funds: authorised unit trusts and open-ended investment companies. Chapter 3 was drafted on the basis that provisions in primary and secondary legislation then in existence would be rewritten in Regulations; and the principal Regulations were accordingly made.

4.2 Regulation 95 of the principal Regulations modifies Schedule 10 to the Finance Act 1996 in its application to authorised investment funds. That Schedule forms part of the loan relationships legislation (see Chapter 2 of Part 4 of the 1996 Act).

4.3 Loan relationship provisions apply to companies to tax interest and other income from lending and economically similar transactions and to allow relief for related types of expenditure and borrowing costs. Of relevance here, the provisions apply where a company has holdings in a unit trust scheme or offshore fund where that scheme or fund fails to satisfy the so called "non-qualifying investments test".

4.4 The "non-qualifying investments test" examines whether the investments held by a unit trust scheme or offshore fund are broadly assets that are, or represent, loan

relationships. If more than 60% of the investments held by the scheme or fund are in assets that give a return which is interest, or is broadly economically equivalent, then the company's holding in that unit trust scheme or offshore fund falls within the loan relationship provisions.

4.5 At the time the principal Regulations were prepared it was intended that primary legislation should be modified so that holdings in open-ended investment companies were treated in the same way as holdings in unit trusts for the purposes of the loan relationships legislation. The consequence would be that such holdings would fall within the loan relationship provisions if they did not satisfy the "non-qualifying investments test". The existing legislation is applied in this manner in practice.

4.6 However, the work undertaken by HMRC's Tax Law Rewrite project during the course of its preparation of legislation rewriting the Corporation Tax Acts has led to doubts as to whether regulation 95 of the principal Regulations does in fact produce the result intended.

4.7 These amending Regulations have accordingly been prepared to provide certainty that the non-qualifying investments test does apply to open-ended investment companies and to confirm what currently occurs in practice.

4.8 These Regulations will enable the Tax Law Rewrite project to incorporate accepted current policy and practice in the rewritten legislation (a draft of which is to be published shortly).

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

7.1 The rules for the taxation of authorised investment funds (authorised unit trusts and open-end investment companies and their investors) are set out in the principal Regulations.

7.2 As a result of the Tax Law Rewrite process an uncertainty in the application of the principal Regulations has come to light.

7.3 The purpose of these amendments to those Regulations is to provide certainty in line with current accepted policy and practice.

8. Impact

8.1 A full and final impact assessment has not been produced for this instrument as it has no impact on business, charities or voluntary bodies.

8.2 There is no impact on the public sector.

9. Contact

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