EXPLANATORY MEMORANDUM TO

THE COMPANIES ACT 2006 (AMENDMENT OF PART 23) (INVESTMENT COMPANIES) REGULATIONS 2012

2012 No. xxxx

1. This explanatory memorandum has been prepared by the Department for Business, Innovation and Skills (BIS) and is laid before Parliament by command of Her Majesty.

2. Purpose of the instrument

2.1 These Regulations amend provisions of the Companies Act 2006 which regulate distributions by investment companies. The Regulations relax the conditions that a company is required to meet in order to benefit from a less restrictive distributions regime for investment companies (compared with other public companies) which already exists under the Companies Act 2006.

2.2 There are three related purposes –

- to make changes to company law which are needed in order to enable changes to corporation tax rules for investment trust companies to have their full intended effect;
- to remove company law provisions for which (in the light of those changes to tax law) there is no longer any good policy justification; and
- to keep the Companies Act conditions in step with those under the corporation tax legislation, thereby maintaining the current position that most investment trust companies benefiting from favourable corporation tax treatment also benefit from the relaxed distributions regime in the Companies Act.

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

3.1 None

4. Legislative context

4.1 These Regulations will amend Part 23 of the Companies Act 2006. Part 23 regulates the distribution of a company's assets (including cash) to its members. This includes dividend payments by companies to their shareholders. Distributions may only be made out of available profits. Companies may make distributions out of realised capital or revenue profits, but a public company (PLC) may only make a distribution if it complies with the "net asset restriction" in section 831. The net asset restriction prevents such a company from making a distribution if its net assets are lower than, or are reduced below, the aggregate of its called-up share capital and undistributable reserves.

4.2 The distribution rules for public companies, including the net asset restriction, implement Articles 15 and 16 of the Second EU Company Law Directive (Directive 77/91/EEC) ("the Directive").

4.3 However, the Directive provides an option for Member States to derogate from the net asset restriction for "investment companies with fixed capital" as defined in Article 15. The UK took partial advantage of this option when implementing the Directive in 1980. It was provided that certain investment companies included within the definition in the Directive could opt into a relaxed distributions regime which allowed them to make distributions out of realised revenue profits without complying with the net asset restriction. To benefit from this regime, they were required to give notice to the registrar of companies, and had to comply with various conditions. The conditions were modelled on conditions in existing tax legislation which applied to investment trust companies wishing to benefit from favourable corporation tax treatment. The policy was that only those companies eligible for such favourable tax treatment should be entitled to benefit from the relaxed distributions regime in the companies legislation.

4.4 The distributions rules in company law and the tax rules relating to the favourable corporation tax treatment of investment trust companies have remained largely unchanged. Under the Corporation Tax Act 2010, companies approved by HMRC as investment trusts are exempt from corporation tax on chargeable gains. In practice, most companies approved by HMRC as investment trust companies also take advantage of the relaxed distributions regime for investment companies.

4.5 However, the conditions for HMRC approval of investment trust companies have been recently amended and are now set out in section 1158 of that Act (substituted by the Finance Act 2011) and in the Investment Trust (Approved Company) (Tax) Regulations 2011 (SI 2011/2999). In the light of those changes, amendments are required to the distributions rules for investment companies, in order to keep them in step with the amended conditions in tax law. Amendments are required in order to enable the changes to the corporation tax rules for investment trust companies to have their full intended effect and to remove conditions in company law which impose additional burdens and for which there is no longer any good policy justification. The Regulations make these amendments. They do so by taking further advantage of the option to derogate under Article 15 of the Directive, relaxing the conditions in sections 832 to 834 of the Companies Act and allowing all of the investment companies covered by the definition in the Directive to be eligible to benefit from the relaxed distributions regime.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 Edward Davey, the Minister for Employment Relations, Consumer and Postal Affairs has made the following statement regarding Human Rights:

"In my view, the provisions of the Companies Act 2006 (Amendment of Part 23) (Investment Companies) Regulations 2012 are compatible with the Convention rights."

7. Policy background

7.1 The distributions regime for investment companies under the Companies Act 2006 makes it easier (subject to compliance with conditions) for investment companies to pay dividends to their investor-shareholders than it would otherwise be if the ordinary rules regulating dividend payments by public companies were to apply. There is also a separate but parallel tax regime in the Corporation Tax Act 2010 under which, subject to conditions, investment trust companies can obtain favourable corporation tax treatment: investment trust companies approved by HMRC are exempt from corporation tax on chargeable gains. Changes have been made to the tax regime, with effect from 1 January 2012, by sections 49 and 50 of the Finance Act 2011 and the Investment Trust (Approved Company) (Tax) Regulations 2011.

7.2 HMRC have modernised the corporation tax rules for investment companies so that unnecessary restrictions on commercial activities are removed, whilst ensuring that unintended tax advantages can not be obtained from investing in investment trust companies. Underpinning this tax reform is the desire to attract investment companies to domicile in the UK. If HMRC's changes to the tax rules are to have their full intended effect, and if it is to remain the case that most approved investment trusts also take advantage of the relaxed distributions regime in the Companies Act, parallel changes to the Companies Act are required.

7.3 These Regulations simplify the existing conditions that investment companies must meet in order to benefit from the relaxed distributions rules in the Companies Act. This should increase the number of investment companies eligible to benefit from the relaxed regime, will keep the Companies Act conditions in step with the recently-amended conditions under the Corporation Tax Act and will enable the amended corporation tax rules for investment trust companies to have their full intended effect. The Regulations:

- amend section 832(5)(a) of the Companies Act so that the investment company's shares must be admitted to trading on a "regulated market" and not necessarily listed on a recognised UK investment exchange as currently required.
- widen the requirement in section 833(2)(a) so that the company's business must consist of investing its funds in "shares, land or other assets" rather than "mainly in securities".
- repeal sections 833(2)(b) and 834 which currently limit the holdings which an investment company may have in other companies.
- repeal section 833(2)(d), which currently prohibits an investment company from retaining more than 15% of its income from securities in respect of each accounting reference period.
- remove the restrictions on investment companies paying dividends out of capital profits if they want to benefit from the favourable regime for making distributions out of revenue profits. Currently, investment companies must not pay any dividends out of capital profits, and must maintain a prohibition on doing so in their articles, if they want to continue to benefit from the relaxed distributions regime.

8. Consultation outcome

8.1 The Regulations are the result of a joint consultation conducted by HMRC, HM Treasury and BIS published on 27 July 2010. This set out the high level policy objectives that underpin these amendments and proposed specific amendments to the Companies Act. Further consultation and evaluation of the evidence provided by industry led to some changes to the proposals.

8.2 BIS published draft amending Regulations on 2 December 2011 with a deadline for comments of 2 January 2012.

9. Guidance

9.1 The primary purpose of these Regulations is to enable changes to the tax rules made by the Finance Act 2011 and under the Investment Trust (Approved Company) (Tax) Regulations 2011 to have their full intended effect and to keep the Companies Act rules on distributions by investment companies in step with the conditions for HMRC approval of investment trusts. We do not propose to publish guidance.

10. Impact

10.1 An Impact Assessment is attached to this memorandum and will be published alongside the Explanatory Memorandum at www.legislation.gov.uk;

11. Regulating small business

11.1 The legislation applies to small business.

11.2 No special provision has been made for small business.

11.3 A waiver from the micro-business exemption has been granted so that investment companies with fewer than ten staff can gain the benefits of the simplification.

12. Monitoring & review

12.1 This is a simplification of legislation so a review is not anticipated.

13. Contact

13.1 Margaret Sutherland at the Department for Business, Innovation and Skills (tel: 020 7215 3585 or email: Margaret.Sutherland@bis.gsi.gov.uk) can answer questions about the instrument.