EXPLANATORY MEMORANDUM TO

THE FINANCE ACT 1995, SECTION 127(12), (DESIGNATED TRANSACTIONS) REGULATIONS 2007

2007 No. 963

THE FINANCE ACT 2003, PARAGRAPH 3(3) OF SCHEDULE 26, (DESIGNATED TRANSACTIONS) REGULATIONS 2007

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

2. Description

2.1 The Finance Act 1995 Regulations extend the definition of investment transaction in section 127(12) of the Finance Act 1995.

2.2 The Finance Act 2003 Regulations extend the definition of investment transaction in paragraph 3(3) of Schedule 26 to the Finance Act 2003.

2.3 In both cases, the extended definition covers transactions in Community tradeable emissions allowances and transferable units issued pursuant to the Kyoto Protocol to the United Nations Framework Convention on Climate Change.

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

None.

4. Legislative Background

4.1 If certain conditions are met, a UK investment manager can carry out an investment transaction as defined without the non-resident incurring liabilities and obligations to UK tax. Those conditions are set out in section 127(3) of the Finance Act 1995 (in relation to income tax or capital gains tax) and paragraph 3(2) of Schedule 26 to the Finance Act 2003 (in relation to corporation tax).

4.2 If the non-resident incurred liabilities and obligations to UK tax, they would be imposed on the UK investment manager by section 126(1) of and Schedule 23 to the Finance Act 1995 (if they related to income tax or capital gains tax) and section 150(1) of the Finance Act 2003 (if they related to corporation tax).

4.3 The regulations are being made to extend the definition of investment transaction in the primary legislation to transactions which were not common when that legislation was enacted in the Finance Act 1995 and the Finance Act 2003.

4.4 The extended definitions do not include transactions which give rise to chargeable gains falling within section 10 of the Taxation of Chargeable Gains Act 1992 (where the charge is to capital gains tax in respect of a trade being carried on by a non-resident through a branch or agency) or section 10B of that Act (where the charge is to corporation tax in respect of a non-resident company carrying on a trade in the UK through a permanent establishment). Such a charge arises where an asset is situated in the UK and used in, held for, or acquired for the trade of, or for the purpose of, the branch or agency or permanent establishment.

4.5 The new definitions reflect representations made by the investment management industry, including those made in response to a consultation exercise carried out by HMRC.

5. Territorial Extent and Application

These instruments apply to all of the United Kingdom.

6. European Convention on Human Rights

As the instruments are subject to negative resolution procedure and do not amend primary legislation, no statement is required.

7. Policy background

7.1 A UK tax liability can arise if a person not resident in the UK invests in the course of the person's trade through a UK investment manager.

7.2 Current tax rules for non-residents include an "investment managers' exemption" (IME) designed to encourage non-residents to conduct investment business through financial institutions based in the UK. Without this, non-residents who have no real presence in the UK would have little incentive to invest through UK investment managers as they would risk being taxed on the basis that they were carrying on a trade in the UK through the agency of the investment manager.

7.3 The IME is available only in respect of investment transactions which are specified in either primary or secondary legislation. The current rules for exemption cover only the type of investment transactions common when the legislation was introduced in 1995 and 2003. Newer and equally legitimate types of transactions are not covered which restricts the service an investment manager can offer to clients.

7.4 These regulations modernise the legislation by including within the exemption transactions in greenhouse gas emission allowances and other

transferable units related to the reduction of greenhouse gas emissions. Such instruments are relatively new, and as they do not fall within the types of financial instrument currently listed in the definition of investment transaction there is no exemption for them, although transactions in derivatives based on them, such as futures and options, can be exempt because the definition of "investment transaction" includes futures contracts and options contracts (and, except in the case of land, does not distinguish between the types of underlying commodity or asset).

7.5 This extension of the IME will encourage trading in instruments which relate to the reduction of greenhouse gas emissions, and so help increase liquidity in the market for these instruments. It will also help investment managers to offer a wider range of services to their clients, and will enable substantial non-resident funds to be placed with UK-based investment managers that might otherwise be managed abroad (contracts with a value of 22.5 billion euros were traded in 2006). It also fits with the Government's priorities on the environment: the Government is committed to building on the EU Emissions Trading Scheme as its main way of pricing carbon in the economy to ensure emissions are effectively limited.

7.6 The policy underpinning the regulations does not apply where emissions allowances and transferable units are held not as financial-type instruments but as assets the disposal of which would give rise to a chargeable gain. Transactions giving rise to chargeable gains are therefore excluded.

7.7 This measure comes in response to requests from the investment management industry to extend the IME to cover a wider range of transactions to reflect modern investment practices. That was mentioned by a number of respondents to the consultation exercise on proposed revisions to the HMRC Statement of Practice (SP 1/01, issued in February 2001) which explains how HMRC apply the legislation. That consultation closed on 12 January 2007.

7.8 This change will be reflected in the revised Statement of Practice when it is issued later this year, and in the updated guidance in the HMRC International Manual that will reflect the changes in the Statement of Practice.

8. Impact

8.1 A Regulatory Impact Assessment has not been prepared for these instruments as they have no impact on business, charities or voluntary bodies.

8.2 There will be no impact on the public sector.

9. Contact

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