Together clear

General Features | Personal tax

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John Buckeridge looks at the reasons for investors of ‘tax-transparent’ schemes for collective investment

Key Points

What is the issue?

Collective investment schemes where the investor is the beneficial owner of a proportionate share of the underlying assets

What does it mean to me?

Potential investors have many different tax treatments depending on their location or category (pension fund, corporate, individual). A transparent fund allows them to retain their own treatment and avoids any unnecessary tax 'drag' from the vehicle

What can I take away?

Only by using transparency for direct taxes on income is it possible to design a fund suitable for investors based in jurisdictions with different tax systems

Tax-transparent funds offer excellent possibilities for cross-border investing and the UK's authorised contractual scheme (ACS) is the latest yet perhaps most carefully drafted addition. For investors in jurisdictions with diverse tax systems only transparency offers the possibility of a common fund that gives appropriate tax results for all.

So, one might ask, why are they not the norm for collective investing?

Background

The growth of unit trusts (and later open-ended investment companies) as entities for pooled investment was enabled by a government tax policy that attempted to give the participant in open-ended collective investment schemes a closely comparable tax treatment to that given to those holding interests directly in the underlying investments.

Given the need to provide reasonably straightforward tax rules, especially for retail investors, this has not always proved simple. A problem in the UK is that different types of income, such as dividends, rental income and interest, are taxed in different ways. This is a legacy of what used to be called the 'schedular system' for income tax. The system today works in much the same way, even though the schedules have been abolished – in theory. This taxes specific income streams by reference to their sources rather than taxing individuals and companies on income generally without regard to source.

When authorised unit trusts (AUT) were relatively simple and mainly held shares of companies that paid dividends, a practical solution was to treat the AUT as if it were a company, put it within the charge to corporation tax (at a rate equal to basic rate income tax), and permit it to pay distributions treated as company dividends to unit holders. The result of this was, for retail investors at least, tidy. It gave individual investors the same net tax result as if they had received the income directly, but with some tax benefit for gains on turnover of assets and deductions for management fees as well as treaty access.

The problems with this relatively neat scenario start if the fund has other types of investors, such as companies, pension funds, international investors and other types of assets, such as bonds, real estate or derivative contracts. Various tweaks to the legislation have addressed some of these issues.

Europe and beyond

To complicate matters, other European jurisdictions have been pursuing their own paths, often with similar objectives, but framed in the context of different tax and legal systems. This has led to a range of fund structures and tax rules across Europe which are typically, as with the UK, tax-neutral for investors but often are not so for investors in other jurisdictions.

The issue, which clearly affects the concept of a single market in financial services, is difficult to deal with on a Europe-wide basis because member states in the EU and EEA have widely varying systems for taxing personal and corporate income and gains. Looked at worldwide, the issue becomes more complex still.

Tax-transparent funds

Over time, it has become apparent that the only type of fund that is likely to have the same tax effect in numerous jurisdictions, and for a variety of categories of investors, is one that is tax-transparent in each of them.

The ‘undertakings for the collective investment in transferable securities’ (UCITS) IV Directive in Europe seems to have envisaged this and has enabled, in principle, the creation of master-feeder fund structures. The logic of this is to set up a tax-transparent master fund. The investors would be feeder funds – probably non-transparent – that could be structured to meet their varied tax needs, perhaps in different jurisdictions if this is beneficial.

Clearly an investor that was tax-exempt in its own jurisdiction could benefit by investing directly in the tax-transparent master fund. So far, the master-feeder structure has had low take-up, but there has been much interest in tax-transparent funds as a vehicle.

Issues with tax-transparent funds

The idea of tax transparency sounds simple enough. In practice, however, it turns out to be complex. The concept implies that, for taxable investors, their tax treatment in their own jurisdiction should be the same as if they directly held a share of the underlying assets of the fund.

In most jurisdictions, investment partnerships are tax-transparent, but they can lead to complex tax calculations. In practice, open-ended partnerships are difficult to achieve.

In the regulated open-ended fund market, the practical, pioneering jurisdictions in tax transparency have been Luxembourg with the *fonds commun de placement* (FCP) and Ireland with the common contractual fund (CCF). In UK tax law, both of these structures are transparent for tax on income, but not (since a recent change) for tax on gains.

In practice, for UK investors, and possibly for many others, it is not clear that the administrators of many FCPs or CCFs have fully understood the implications of tax transparency. This means that in some instances they may not be providing all the information that all investors need to comply with their tax obligations in their own jurisdiction. For UK investors at least, relying on the actual distributions of such a fund is not sufficient or even relevant to determining the taxation of investors on income – although distributions have a role in determining the final gain or loss on disposal in a fund that is opaque for gains. If the fund holds UK property, a unit represents an interest in that land and property and stamp duty land tax (SDLT) (and/or Scottish land and buildings transaction tax LBTT) should apply on transfer or subscription.

UK domiciled funds – ACS

In 2013, after consultation and detailed work with industry, accounting and legal experts, the government legislated to permit two legal forms for authorised contractual tax-transparent arrangements, described generically as ACS. Here, the form of co-ownership fund is considered because it has attracted the most interest and fund launches. The second type of ACS is a form of limited partnership.

ACSs are authorised and regulated funds and can be set up as UCITS, non-UCITS retail schemes, or as the lightly regulated Qualified Investor Scheme. Although the complexity of tax-transparent arrangements renders them unsuitable for most individuals, the UCITS schemes remain potentially important, both as a master fund into which ordinary retail schemes can invest, and for some institutional investors.

The ACS co-ownership fund is a new departure for the UK, with some similarities to existing European contractual fund structures. An ACS co-ownership fund is formed by means of a contract for the pooling and management of assets. The arrangement has no legal personality and is not, in its own right, within the charge to any UK taxes. If a UK or foreign tax charge falls upon the investors (as the co-owners of the assets managed), the fund manager may settle these taxes on their behalf from fund assets. The obvious cases here are with transaction taxes, such as VAT and stamp taxes.

Although the co-ownership ACS is transparent for income and most other purposes, the UK has put in place legislation for the taxation of capital gains. Much as the existing UK treatment of investors in similar contractual funds offshore – apart from partnerships – investors are taxed on gains on disposal of units in the fund and not when the fund makes disposals of assets.

The advent of the UK ACS has re-ignited interest in tax-transparent funds generally and, at the same time, in the context of a regulated environment, focused attention on some of the difficulties with administering tax-transparent funds, whatever the jurisdiction.

As well as attracting industry interest, the ACS has generated early significant fund launches. As a result, some fund administrators are working hard to establish systems, particularly for daily or monthly reporting, so that investors can meet their UK tax obligations or those of other jurisdictions. UK administrators are building expertise relevant to meeting the needs of investors with tax reporting requirements, whatever the jurisdiction.

Detailed reporting also enables investors with treaty rights in their own jurisdiction to access their rights to recover part or all of any withholding tax charged by the jurisdiction where the assets are invested. The fund administrator or depositary will demonstrate the rights to lower (or zero) treaty withholding rates on behalf of the investors.

Pension funds in the UK and other jurisdictions have access to zero treaty withholding rates with some treaty partners, and it has, in the past, been difficult for these investors to benefit from the economic advantages of pooling and have access to their treaty rights. ACS solves this, offering the possibility of pooling assets at the same time as retaining for those investors their own tax characteristics on their share of the pooled assets.

Conclusion

Given the structure of the EU, which seeks to encourage cross-border trading and investing while leaving responsibility for direct taxation entirely with the individual member states, the development of tax-transparent funds is probably overdue. It is only by using transparency, at least for direct taxes on income, that it is possible to design a fund suitable for investors in jurisdictions with different tax systems and where the investors may themselves have varying tax characteristics.

For investors whose needs are better addressed by an opaque arrangement geared to their own tax status, for example all taxable retail investors, very large tax-transparent funds can still be accessible using the master-feeder model, which we may yet see.

In the UK there is already great interest from tax-exempt pension funds, and, as well as securities funds, significant real estate ACS funds have already been launched, even though the government is still working on the stamp duty land tax treatment of investors in these.