THE
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Dear Sir/ Madam

HM Treasury consultation: reform of the substantial shareholdings consultation

The Investment Association[1] welcomes the opportunity to respond to HM Treasury's consultation on the reform of the substantial shareholdings exemption (SSE). In particular, we welcome the specific consideration of the possible application of the SSE to funds, outlined in section 5. This letter addresses the question in that section.

The consultation mentions competitiveness of the UK as an important factor in considering reform. The UK's competitiveness has become even more important since publication of the consultation. Brexit will result in an uncertain business landscape for some time, during which maintaining the UK's attractiveness as a place to do business is more important than ever.

The Investment Association strongly supports the introduction of an effective exemption from tax on capital gains on disposal of shares for funds with substantial shareholdings.

As is highlighted in the consultation document, the inability of funds to benefit from the SSE has historically impacted on the UK's attractiveness as a fund location. This is particularly the case for alternative funds investing in infrastructure, real estate, and portfolios of private equity and debt.

Fund structures

In the UK, the requirement that funds should benefit from exemption from tax on capital gains is recognised for some fund structures, such as Open Ended Investment Companies, Authorised Unit Trusts and Investment Trust Companies (s. 100 TCGA 1992). This requirement results from the need to ensure that investors in funds should only be liable to tax on gains once (at the level of their holdings in the fund) rather than twice (at fund and investor level) or multiple times if the fund has intermediate holding companies.

[1] The Investment Association is the trade body that represents UK investment managers, whose 200 members collectively manage over £5.7 trillion on behalf of clients.

Many other jurisdictions have a participation exemption that achieves the same result for a wide range of holding companies that can act as fund structures. The lack of a similar exemption in the UK has led to funds being domiciled in other territories such as Luxembourg and Ireland. Broadening the scope of the SSE would level the playing field.

Although reforming the SSE would not result in a wholesale shift of funds to the UK, it would over time encourage new funds to consider the UK as a credible domicile option, as well as possible re-domiciliation of funds. With Brexit, funds which are currently domiciled in the UK may be looking to re-domicile elsewhere in Europe. Improving the UK tax landscape could deter such a move. The funds industry should not be disadvantaged by less favourable tax rules in the UK than in European and other jurisdictions.

The purpose of investment funds

Investment funds serve an important social purpose in the pooling of capital from a number of sources to finance economic activity. Capital may be pooled from pensions and other forms of savings vehicle used by individuals, as well as from life assurance companies, endowments and charities. The capital raised is used to finance small and medium-sized enterprises (SMEs) through private equity investment, infrastructure projects, and commercial and residential property. As the volume of traditional lending to SMEs and infrastructure projects has been in decline, the need for alternative sources of financing has never been greater.

From an investor's point of view, funds are an essential savings vehicle, particularly for smaller savers and investors that otherwise lack the scale necessary to access the capital markets. The importance of funds as a vehicle for long-term saving is all the more relevant today, when individuals are increasingly being called upon to make their own provision for retirement. Funds are also valuable for medium-term saving at this time of historic low interest rates. It is critical that fund structures provide investors with equivalence in tax treatment compared with direct owners of assets.

The tax neutrality of funds is recognised in tax regimes throughout the world. Subjecting funds (and asset owning companies that are wholly owned by funds) to taxation on capital gains goes against this premise, but could be rectified by modifications to the SSE regime.

Question 14: Is there a case for reform of the SSE to be targeted towards the funds sector?

We would support modifications to the existing SSE regime that would enable the UK to become a competitive funds domicile for institutional investors. This could be achieved by using similar provisions to those that exist for UK-based authorised funds and investment trusts, but without the need for the funds to be subject to regulation that is primarily targeted at those that are distributed to retail investors. The provisions relate to: a) the purpose of the vehicle (which, broadly speaking is set out in s. 235 FSMA 2000 for open-ended funds and in s. 1158 CTA 2010 for investment trusts); and b) the requirement to distribute income in the fund (which is a requirement of COLL for authorised funds and set out in SI 2011/2999 for investment trusts).

We believe that s. 235 FSMA 2000 provides the widest possible comprehensive definition of 'collective investment scheme' for this purpose. Such collective investment schemes can be authorised or unregulated. Currently, authorised funds have access to a special tax regime (particularly s. 100 TCGA 1992 and AIF Regulations (SI 2006/964)), but unregulated funds are treated in the normal way according to their legal structure if set up in the UK (which is untypical).

Many alternative funds are required, for legal or funding purposes to have wholly owned asset owning companies within them. For example, in some countries it is a legal requirement that any company owning real estate should be a locally resident company. Therefore the extension of SSE to funds should also include companies wholly owned within a fund.

There are strict limitations as to how unregulated funds can be marketed and distributed, and we believe that these limit the risk of such funds being used for tax avoidance. Moreover, there are extensive anti-avoidance provisions already in place that prevent the use of funds for holding passive investments in low tax environments which can be repatriated tax free (point 4.12 of the condoc), such as the offshore funds rules, and the requirements to distribute income in the investment trust regulations.

Thank you again for the opportunity to respond to the consultation and we hope to continue to be able to contribute. If you would like to discuss anything in this letter, I am available at jorge.morley-smith@theia.org or on +44 (0)20 7831 0898.

Yours faithfully

Jorge Morley-Smith
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