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REVIEW OF THE UK FUNDS REGIME: HM TREASURY SETS OUT CONCLUSIONS AND NEXT STEPS TO IMPROVE UK'S ATTRACTIVENESS FOR FUNDS

14 February 2022

SUMMARY

On 10 February 2022 HM Treasury published a response document (**Response**) to its January 2021 'call for input' on a review of the UK funds regime. The review was necessarily wide-ranging, covering direct and indirect tax, relevant areas of funds regulation and opportunities for wider reform. The key output from the Response is a shortlist of priority areas that the Government intends to action, including various areas for detailed exploration, consultation and discussion. The Government welcomes further input on topics that have not been prioritised in this process, suggesting that further reforms are likely in the medium to long term. Out of scope are AIFMD and UCITS-related legislation and ESG considerations – although various feedback points in these areas are noted, in particular that the UK funds regime review will help facilitate the role of the UK asset management industry in the transition to net zero.

Three top priorities were identified by respondents in the feedback process. These form an anchor point for the Government's to do list.

- First, the introduction of a new open-ended authorised fund vehicle that can invest in a full range of illiquid asset classes. The Long Term Asset Fund (**LTAF**), enshrined in a new chapter in the COLL Sourcebook, has been available since November 2021. The Response reiterates the Government's focus on the LTAF and ongoing work to facilitate its rollout. Active Government engagement on the LTAF includes a continued assessment of the case for any changes to the tax treatment of LTAFs, a consultation (due in H1 2022) on the wider distribution of LTAFs to non-sophisticated retail investors and ongoing work of the Productive Finance Working Group considering impediments to investment in long-term assets.

- Secondly, to address the priority to fill the gap in the UK's unauthorised professional investor fund range, the Government intends to explore a contractual structure that is closed-ended, unlisted, with tradable units and expected to largely replicate the tax rules for CoACS. The

Response sets out the key structural features proposed, noting that the proposed new unregulated fund vehicle could act in conjunction with the authorised LTAF, be implemented with relative ease and supports the Government's work to promote investment in longer-term, less liquid assets.

- Thirdly, the VAT treatment of fund management services (which can create incentives for funds to domicile outside the UK currently). Being run as a separate work stream, the Government will be looking at competitive treatment of fund management fees, but significantly, it has ruled out zero-rating management fees for now. A consultation is expected in the coming months.

The introduction of the Qualifying Asset Holding Company (**QAHC**) regime is, similar to the LTAF, another limb of the overall UK funds review already introduced. The QAHC regime is intended to rival other fund holding regimes, with the hope of attracting more asset holding company structures to the UK and to capitalise on the strength of the UK investment management sector. It applies from April 2022.

We have set out below the key issues from the Response of interest to, and having an impact on, the UK funds sector in the following three areas: taxation, regulation and wider reform. Any changes will be in line with the Government's commitment to uphold the UK's high regulatory standards and will be compatible with its robust approach to tax avoidance and evasion.

Funds taxation

As mentioned above, and despite much campaigning from industry, zero-rating the VAT treatment of fund management fees is not being pursued at this stage. Zero-rating was seen as a solution to irrecoverable VAT in fund structuring. However, the Government will look at other options to improve and simplify the VAT regime for fund management.

The Government has signalled its continued support for the REIT regime by announcing it will build on the reforms taking effect from April 2022 by considering further simplification, and improvements to accessibility, of the regime. On the table are considerations initially suggested by HMRC (see our previous blog on those suggestions) as well as further ideas raised by industry in the call for input. No decision has been made yet on which reforms will be taken forward, but they are likely to be adopted in a two-stage approach. The first stage will include resolving the interaction of the REIT regime with the QAHC regime. The later stage will include a review of the non-close condition for REITs.

The Government will review the genuine diversity of ownership (**GDO**) test, used in different funds tax regimes as a requirement for beneficial treatment within the regime. It will consult on making the GDO test simpler and more efficient. Essentially the test requires that the fund be widely marketed.

The Government will explore the case for an elective tax-exemption for authorised funds. Having the exemption as optional may address concerns about the impact on double tax treaties if an exemption applied. The exemption will not be considered for unauthorised funds because the Government is not introducing zero-rated fund management fees.

The Government will continue to engage on improving its tax treaties now that the UK is outside the EU and UK entities are no longer able to access exemptions from withholding tax on the payment of dividends and interest between EU Member States. It will seek clarity of treatment for particular fund structures with partner countries where necessary.

For multi-asset funds (holding investments in both equities and debt), which are at risk of suffering 'tax drag' at the fund level, the Government will consider a deemed deduction for distributions as this would preserve access to double tax treaties or a tax exemption (see above).

The call for input raised issues around various barriers to the use of UKLPs and PFLPs (the number of registrations has declined in recent years) and how tax changes may help address them. The Response reiterates that the Government is keen to support UK limited partnerships in general and that measures mooted some time ago to increase levels of transparency (for example, a requirement for UKLPs to maintain a UK connection and to extend reporting requirements) are still on the agenda, still stated to follow "when parliamentary time allows". Although it does not intend to progress with creating bespoke partnership taxation rules or address other non-tax related concerns (for example allowing English limited partnerships to elect to have legal personality or modernising the system for transfer of fund interests) the Government is open to additional representations. It will be considering further simplification of partnership tax reporting requirements.

Funds regulation

There are three areas of attention.

- First, fund authorisation. The Government found that the FCA's fund authorisation timeframes are appropriate, and does not intend to follow up on a suggestion in the original call for input that the statutory target for Qualified Investor Scheme (**QIS**) authorisations be reduced, from 6 months to 1 month, which would align with the FCA target for completed applications received. Difficulties and uncertainties experienced in the authorisation process, in particular FCA comments and queries raised late in the day, pose an area where improvements could be made. The FCA will engage with the industry to produce additional guidance and information to help AFMs navigate the process. The Response does not mention the LTAF authorisation window (6 months) and any commitment to reduce this.

- Secondly, speed to market. The Response sets out the merits, complexities and potential risks to investors of a 'fast-track' authorisation process, potentially supported by solicitor-certified authorisation documents for professional-only AIFs. However, this is not perceived as a priority in the short term.

- Thirdly, improvements to the QIS authorised-fund structure. The Government notes (and has shared with the FCA) various suggestions made in the feedback process to make the QIS more attractive to professional investors – for instance, extending the range of permitted investments, relaxing the borrowing and derivatives constraints, permitting distribution of capital (see paragraph below for more on this) and accommodating carried interest arrangements. Although some of these proposed enabling provisions have been addressed as part of the development and launch of the LTAF, the FCA is still open to potential reform of the QIS. This will be weighed up alongside wider organisational priorities, such as consulting on the broader distribution of the LTAF to retail investors. The proposal to introduce sub-fund structures for QIS and AUTs is, again, not a priority.

Opportunities for wider reform

Further highlights from other areas covered in the Response are as follows:

- Scope for the UK to improves its positioning in respect of AIF targeting international markets, ensuring that reforms reflect the needs of UK and international investors – the Government has and will continue to consider and assess views and areas of opportunity.

- The Government intends to explore further how the distribution of capital from authorised funds could be permitted to allow managers to develop products that offer investors a long-term, sustainable and predictable level of income – and hence appeal to pension and retail investors. A cross-agency working group between HMT, HMRC and the FCA is to consider options. Consumer protection and appropriate tax treatment will be key.

- Spreading the benefits of fund administration across the UK. The Response is open to views and suggestions and highlights specific commitments made to support this wider focus area in the Spending Review 2021 and the recently published Levelling Up White Paper.

- Additional specific policy reforms on Investment Trust Companies are not to be progressed, given that the FCA is already pursuing policies that tackle the key points raised by respondents – including prospectus reforms, addressing challenges in the financial advice market and emphasising the needs of retail consumers via a new Consumer Duty.

For background on the original call for input, see our Funds First Spring 2021 update.

For background on the REIT amendments, see our February 2021 briefing Promoting UK funds - potential reform of the UK REIT regime.

On the QAHC regime, see our August 2021 briefing Promoting UK funds – Can the new qualifying asset holding company compete with Luxembourg?

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