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Insights

SPRING BUDGET 2020: OVERVIEW FROM A FUNDS PERSPECTIVE

17 March 2020

SUMMARY

This briefing summarises the key announcements in the Spring Budget from a funds perspective: including the UK funds review, the SDLT surcharge for corporate and individual non-resident purchasers of UK residential property and VAT on fund management services. It also contains some general updates which will be of interest to those in the funds industry.

Review of the UK funds regime during 2020

In the Spring Budget the Chancellor announced a review of the UK funds regime in 2020 and repeated the government's commitment to the competitiveness of the UK asset management sector. This review will be informed by industry representations, in particular the extensive recommendations made in the June 2019 report to the HM Treasury Asset Management taskforce by the Investment Association (IA). It will take into account tax treatment as well as the regulatory environment. The IA paper proposes two new fund structures - a new open-ended authorised fund structure/regime, the Long-Term Asset Fund (LTAF), and an Onshore Professional Fund, a competitive unregulated fund vehicle. The aim being to make a significant difference to the attractiveness and effectiveness of the UK funds regime for both domestic and international customers. Further detail on this review is to follow "in due course".

In the meantime, to kick things off the government is consulting on two targeted areas of tax reform. Firstly, reviewing the attractiveness of the UK as an intermediate holding company location through which alternative funds hold assets. Secondly, it will consider the VAT treatment of fund management fees.

Consultation on tax treatment of asset holding companies (AHC) in alternative fund structures

In relation to intermediate holding companies, the government is consulting on barriers to locating AHCs in the UK. Having done so it will then decide on the merits of removing the barriers. Reform is

not a foregone conclusion. We have set out below a few of the challenges identified.

- For real estate funds two principal issues are identified. These are the limited exemption from UK tax on capital gains for selling shares where the seller is owned at least 80% by “qualifying institutional investors" (the Substantial Shareholding Exemption). The issue is the satisfaction of the 80% institutional investment test where there is a mixed institutional/non-institutional investor base, and also the risk of changes to the investors over time where the hurdle is satisfied at the outset. In addition, the Consultation is looking at rent received by a UK AHC, and whether possible UK tax leakage on rental income flowing through an AHC could be addressed by changes to the UK REIT regime (we would ask, however, if there might be simpler alternative solutions to this).

- In the private equity context the Consultation identifies a difficulty in retaining the capital nature of the investment return when the UK AHC disposes of a target company and returns value to the fund. The UK’s distribution rules can mean that even if, for instance, the funds are extracted under a repurchase of shares, they still may be treated as an income distribution for UK tax purposes. Certain groups of investors, notably UK resident individuals (who may be carry holders) are in general taxed more highly on income than capital returns.

- For credit funds an issue for a UK AHC arises in circumstances where an AHC issues limited recourse notes to pass on any investment income to the fund and its investors, where it may not be taxed on just the financing margin it earns. Amending the taxation of securitisation company rules to account for this has been mooted. However, the government does not seem too keen on the idea of amending the securitisation rules to accommodate AHCs for credit funds, but is open to discussing it further.

- The Consultation highlights the more general issue of withholding tax on UK source interest. Whilst recognising the availability of existing exemptions, including the quoted Eurobond exemption and the qualifying private placement exemption, the government questions whether modified rules on interest withholding might be beneficial to ease the administrative burden of meeting the current exemptions.

- There are various concerns with the hybrid mismatch rules, which could deny a tax deduction. The government is interested to hear where the issues arise and how other jurisdictions might have overcome them.

The government is weighing up whether to tackle these matters in a series of isolated changes, or alternatively proposing a more comprehensive approach. The latter approach could involve a new set of rules for certain defined investment fund structures, including a more relaxed exemption on the sale of shares, modified rules on interest withholding tax and a different approach to calculating the liability to corporation tax. An equivalent to the securitisation companies tax regime is being considered, which broadly taxes on “retained profit”. Changes inconsistent with UK tax principles,

that remove existing UK taxable income and/or gains from the UK tax net, or that create abuse/avoidance risks, will of course not be acceptable.

The consultation will run until 20 May. No timeline for any reform is otherwise outlined.

The industry will be following developments in this area with acute interest and attention. We would be happy to assist our clients and contacts in discussing with you any thoughts you may have on the proposals in order to formulate a response.

VAT treatment of fund management fees

In relation to VAT on management fees, there was less detail in the Budget announcements, which contained a commitment to work with industry on reviewing the VAT treatment of management fees, but without producing a consultation. It is to be hoped that the government will use its upcoming freedom from EU rules to amend the VAT regime in ways beneficial to UK-based managers, to extend the circumstances when management services may be supplied exempt of VAT (beyond the current scope of the "special investment fund" exemption), and possibly also to have regard to investment managers' VAT recovery position (as with the recent welcome confirmation that investment management supplies to non-EU pension funds are effectively zero-rated).

An immediate action point for investment managers is to review current investment management agreements (IMAs) to ensure they give the desired result should rules on VAT liability and VAT recovery change during the term of the IMA. In the past, widenings of the "special investment fund" VAT exemption have caused a number of investment managers to be out of pocket, when a widened VAT exemption has left managers with increased irrecoverable VAT, without the relevant IMAs allowing for the managers to pass the cost of this increased irrecoverable VAT on to their clients.

Other announcements, including on SDLT

We have picked out three other updates which will be of interest to those in the funds industry.

- As announced before, there will be an SDLT surcharge for corporate and individual non-resident buyers of UK residential property. The money raised from the surcharge will be used to help tackle rough sleeping. Rather than the proposed 3% it will be at 2% and it will not be introduced until 1 April 2021. Where contracts were exchanged before 11 March 2020 but complete or are substantially performed after 1 April 2021, transitional rules may apply, subject to conditions. It is hoped that large acquisitions involving 6 or more residential units will be subject to the commercial rates of SDLT - with the consequence that the surcharge does not apply in practice to such acquisitions.

- A consultation on an Overseas Funds Regime (OFR) that closes on 11 May 2020 proposes a more streamlined regime for selling overseas funds to UK investors pending the loss of the UCITS passport post-Brexit. It involves two new regimes, both of which will operate on the basis of 'outcomes-based equivalence' – one for retail investment funds and one for money market funds. Funds recognised under the OFR will be subject to obligations on disclosure, provision of investor facilities in the UK, reporting to the FCA and payment of regulatory fees. Although retail schemes will not be required to notify under the National Private Placement Regime (NPPR), the FCA proposes that operators under the OFR will have to separately adhere to the UK financial promotions regime (and therefore have to use UK authorised persons to make or approve financial promotions). Whilst the amending legislation itself (and the list of likely jurisdictions to be granted equivalence) has not been published, the regime outlined would appear to be a pragmatic solution to the issue.
- Response on the financial services regulatory review. A new Regulatory Initiatives Grid is to be launched over the Summer, and published twice a year, setting out a two-year forward-look at and indicative timetable for major regulatory initiatives affecting the financial services sector. This should provide better structure, clarity and coherence for both stakeholders and regulators in the sector.

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