

# TAX-EFFICIENT INVESTMENT FOR HIGH NET WORTH INDIVIDUALS AND FAMILIES

Collective investment vehicles following the 2005 budget statement

## THE EXISTING TAX REGIME

In recent years, there has been an increasing amount of interest on the part of high net worth families in investing through 'private' collective investment vehicles. The aim has been:

- ▶ to enjoy the favourable tax treatment given to such collective vehicles; but at the same time
- ▶ to retain greater influence over investment strategy than would be the case if funds were invested directly in a portfolio of authorised unit trusts and similar vehicles.

Many families have chosen to invest through 'private' authorised unit trusts and open ended investment companies (OEICs). The principal tax advantages are:

- ▶ investment management expenses are deductible in determining the amount of income taxable in the investor's hands
- ▶ such vehicles are not taxed on their capital gains, any capital gains tax being payable only by the investor when units or shares in such vehicles are sold or transferred.

Other families have invested in offshore vehicles, which may adopt more flexible investment and borrowing strategies than the authorised UK vehicles, while retaining some of the tax advantages. These have been the subject of UK anti-avoidance legislation for some time, including:

- ▶ income tax charges on gains on sales of shares or units, unless the scheme distributes most of its income

- ▶ provisions which may render offshore vehicles liable to UK corporation tax on some of their income if a substantial interest is held by a UK investment manager and persons connected with the manager.

It is also necessary to bear in mind the general anti-avoidance provisions under which income or capital gains arising from investment assets taken offshore may be taxed in the hands of the UK investor.

Some offshore investment vehicles (notably US limited liability partnerships) are tax-transparent for UK tax purposes (that is to say the investor is taxed directly on his share of the income and gains of the partnership). While some investors may regard this as acceptable, it may be difficult to obtain details of underlying income and gains for the purposes of completing UK personal tax returns, especially where only a small percentage interest is held.

Nevertheless, offshore vehicles may be useful, especially for investors who are not domiciled in the UK.

## THE BUDGET STATEMENT 16 MARCH 2005

It was announced at the time of the Pre-Budget statement in November 2004 that the Government believed that some uses of these tax-efficient structures were abusive, and that legislation would be brought forward to counter it. The announced intention was to restrict the favourable tax treatment of authorised investment funds (i.e. authorised unit trusts

and OEICs) to those funds where each investor holds less than 10% of the fund.

The budget announcement which finally appeared was much more restricted in its scope, at least as regards the proposals for the 2005 Finance Bill. The immediate attack is being directed at Qualified Investor Schemes (QIS). These are authorised collective investment schemes which have a wider degree of flexibility as regards permitted investments, but whose membership is restricted to more sophisticated investors. The proposed legislation will apply to investors who hold a 'substantial' proportion of a QIS, and will impose an income tax charge on any annual increase in value of the holdings. In determining whether a 'substantial' proportion is held by any individual, account will be taken of units or shares held by 'connected parties and associates'. The detail of this has not been announced, but is likely to include holdings of certain family members and family trusts. It is possible that the final legislation will be targeted on arrangements made for the purpose of avoiding tax (although it remains to be seen how easy it will be to demonstrate a motive other than tax avoidance).

While there is no immediate threat to other types of vehicle, it is clear from the announcement that these remain under the spotlight, and one must therefore be prepared to see in the future other measures of wider application.

## OTHER PROPOSED CHANGES

Currently, distributions may be paid in the form of interest (subject to deduction of tax at source which is potentially repayable to investors who are non-taxpayers or who only pay income tax at the 10% 'starting rate') by funds which are substantially invested in bonds. The budget announcement includes proposed changes to the rules which determine the extent to which interest distributions can be paid by a fund invested in a mixture of bonds and equities. Those who have investments in family funds of this type may wish to review distribution policies in the light of the changes.

## THE WAY AHEAD

- ▶ Investors should confirm whether or not they have a QIS in their portfolio.
- ▶ The restricted nature of the immediate Inland Revenue attack will no doubt come as a relief to many. The QIS is a special type of investment vehicle, specifically authorised as such by the Financial Services Authority, and accordingly the legislation currently proposed with regard to these schemes cannot have application to the generality of family unit trusts and OEICs.
- ▶ More sophisticated investors who already have an investment in a QIS will need to consider how their personal tax position is affected, and the merits of changing to alternative investments which still enjoy a more

favourable tax treatment, when the full details of the proposals emerge. Others who have been contemplating entering into an arrangement involving a QIS will need to consider its advisability in the light of the new announcement.

- ▶ While this clearly sets a precedent for other types of fund, a simple extension of the proposed QIS tax regime to the generality of unit trusts and OEICs looks unlikely, since the proposed treatment of the QIS appears intended to recognise that the underlying gains being achieved by the QIS are more likely to be of an income, rather than a capital, nature. However, the announcement has certainly done nothing to disperse the clouds on the horizon for family-held collective vehicles in general; those with investments in such vehicles, or intending to set up such vehicles in the future, should keep the likely tax position under review with their advisors.
- ▶ Distribution policies for some schemes may also have to be reconsidered.

*Please note that collective investment vehicles may not be suitable for all clients and more specific advice should always be taken.*

If you would like further information or advice, please contact any of our partners with whom you are already in contact or one of the writers:

### **Robin Thomas**

robinthomas@dixonwilson.co.uk

### **Philip Pickles**

philippickles@dixonwilson.co.uk

### **David Mellor**

davidmellor@dixonwilson.co.uk

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▶ Dixon Wilson  
Rotherwick House  
3 Thomas More Street  
London E1W 1YX

Telephone 020 7680 8100  
Fax 020 7680 8101  
E-mail [dw@dixonwilson.co.uk](mailto:dw@dixonwilson.co.uk)

▶ Dixon Wilson  
19 avenue de l'Opéra  
75001 Paris  
France

Telephone +33 1 47 03 12 90  
Fax +33 1 47 03 12 85  
E-mail [dw@dixonwilson.fr](mailto:dw@dixonwilson.fr)

▶ [www.dixonwilson.com](http://www.dixonwilson.com)