ASSOCIATION OF UNIT TRUSTS
AND INVESTMENT FUNDS

AUTIF REPRESENTATIONS FOR PRE-BUDGET REPORT NOVEMBER 2001

The Members of the Association of Unit Trusts and Investment Funds (AUTIF) account for 99% of funds under management in UK regulated collective investment schemes – a total of £239bn at the end of August.

ISAs

1. Permit transfers between Cash and Stocks & Shares components of an ISA

The Government's objective for the introduction of ISAs was to "encourage people, through tax reliefs, to raise the level of their long-term savings." This savings objective was specifically directed at those "on modest incomes".[1] With an increase of approximately 85% in the number of accounts in tax-exempt savings and investment products from March 1998 to March 2001, it is encouraging to see that ISAs are achieving their main objective.

Around 57% of the total amount invested in ISAs is currently held within the cash component. Because under the current rules this percentage is likely to increase over the next few years, in particular due to maturing TESSA proceeds being subscribed to ISAs, there is likely to be a considerable sum retained and ring-fenced in the cash component. In the current economic environment of low interest rates, the returns available to investors will be limited for cash.

The prime focus of portfolio management is to apportion savings between different areas of the market, e.g. cash, equity and bonds. Inexperienced investors, who previously subscribed all their savings to cash ISAs or TESSAs, are now unable to increase their long-term risk/reward trade-off by transferring their savings into the stocks and shares component. An additional flexibility to transfer between components would not only benefit the investor but also the economy. The investors' savings will be exposed to investments which promote capital growth and may also provide income and long-term aggregation of funds for retirement income. Tax-payers will benefit in that more people will be financially prepared for retirement or unexpected circumstances, which in turn should reduce public spending. Also, this provision would reduce the amount of tax foregone by the Revenue because of the higher level of tax on interest income.

AUTIF therefore recommends that provision is made to allow transfers from the cash component to the stocks and shares component. We appreciate that there would be implications if transfers between components were available in the year of subscription and we would therefore urge the Treasury to accept inter-component transfers in subsequent tax years without restriction.

[1] The new Individual Savings Account – Inland Revenue December 1997

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2. Retention of tax credits on ISAs

The Government announced in the 1998 Finance Act that tax credits on distributions received in respect of an ISA or PEP would continue to be treated as paid until 5 April 2004, thus boosting the value of savers' income by one-ninth, an uplift which is not available to investments made outside the ISA or PEP wrapper.

If this tax credit is lost, equity ISAs would be placed at a direct disadvantage relative to both ISAs invested in bond funds, which pay interest distributions, and cash ISAs, as these products will continue to benefit indefinitely from a tax uplift of one-quarter on interest received. We believe the playing field for different types of product should be more level. It would also mean that equity ISAs would no longer have a tax benefit for basic rate taxpayers who do not pay Capital Gains Tax, because income received inside an ISA would be identical to income received outside the wrapper. Retention of the tax credit on dividends would help to maintain the appeal of these products, and would encourage savers to keep faith with the stock market during difficult periods.

The ISA regime has been successful in encouraging the general public to take out investments in stocks and shares, with £21bn invested in unit trust or oeic ISAs since the regime was introduced in 1999. Stocks and shares have been shown to be consistently better investments than deposits in banks or building societies in the longer term, and therefore more likely to provide the growth and income essential to adequate long-term savings provision.

Recent inflows to ISAs gave fallen away significantly in the wake of falling equity markets and financial uncertainty. It would be very unfortunate if ISAs were to receive a further blow in the form of a loss of the tax incentive following such a period. This would be very damaging to the Government's objective of encouraging long-term savings.

AUTIF therefore recommends that the availability of these tax credits be continued indefinitely.

3. Simplify ISA subscription limits for monthly savers

An important mechanism for encouraging people to save is the monthly savings plan. For many investors this is a relatively painless way of saving. Once established, a monthly savings plan allows for a relatively small amount of money automatically to be transferred from the saver's bank account each month without any action needed on their part. It is also administratively straightforward for the ISA provider. But a very irritating consequence of the current ISA subscription limits, for both savers and providers, is that the maximum of £7,000 for the equity component is not divisible by 12. This results in additional administration and costs for the industry for the last month of each tax year, and additional hassle for investors.

AUTIF fully supports the Government's desire to promote a wider and deeper savings culture. We believe that the ISA has been successful and will continue to be an important element in encouraging people to save, provided that "hassle" factors for savers are kept to an absolute minimum.

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AUTIF recommends that the subscription limits be amended to a figure divisible by 12 (e.g. £7,200) to simplify the administration and reduce costs for providers and investors alike.

4. Eligibility of Futures and Options Funds and other funds that use derivatives

Futures and Options Funds are collective investment schemes dedicated to approved and other derivatives (where most or all of the transactions are fully covered by cash, securities or other derivatives), whether with or without transferable securities.

There is a number of characteristics of such funds, which are of benefit to retail investors, and which support the industry's request for them to be qualifying investments for PEPs and for the stocks and shares component of ISAs.

A guaranteed or protected fund offers a safe method of encouraging people on modest incomes to gain exposure to equity markets and their long-term gains while limiting the potential downside risk. We believe that these types of fund can offer a very attractive product for individuals who are taking their first step into equity investment. The benefit of this type of product to risk-adverse investors has been highlighted by the aftermath of the events of 11 September. The market performance of these types of fund has been relatively unaffected, whereas securities or warrant funds have generally sustained substantial losses.

Futures and Options funds can mimic the outcome of with-profits products, but with a number of additional benefits:

- Collective investment schemes (CIS) are a highly regulated product with various investor protection safeguards.
- The pricing of CIS is based on a strict net asset value calculation.
- CIS are subject to disclosure requirements that ensure their transparency; there are no hidden charges.

Despite these benefits, investment in guaranteed or protected futures and options funds does not qualify for the same tax advantages as life products. If managers could offer this product within an ISA wrapper, there would be a level playing field for tax purposes.

We note the concern previously expressed by the authorities that extending qualification to Futures and Options Funds might be used to create funds little different from a cash account, by mimicking the risk/account profile of a deposit account. However, the very clear difference between a Futures and Options Fund and a cash account are the tax implications. Any interest earned on a cash account within an ISA enables the manager to reclaim the 20% income tax. However, distributions payable by a futures and options fund are defined as dividend distributions and as such will only receive the 10% tax credit.

Furthermore, the revised UCITS Directive, which is expected to be adopted by the end of this calendar year with an implementation deadline of mid-2003, will render the existing categories of funds redundant. The current UCITS Directive basically restricts

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UCITS to investments in "transferable securities". However, the revised Directive will enable UCITS to invest in a wider variety of instruments – deposits, money market instruments, derivatives and other funds – within set investment limits and with no ability to gear or invest in eg property. Moreover, any one UCITS could invest in a mixture of instruments. For example, a fund will be able to invest in other collective investment schemes alongside direct investment in transferable securities.

Therefore, in order to implement the revised Directive, for UCITS-compliant funds the FSA will have to remove the current distinctions between categories of fund. Consequently, the concept of Securities, Warrants and Fund of Funds Schemes will no longer exist. In order to meet our EU obligations, we suggest the simplest route would be to make all UCITS-compliant funds eligible for PEP and ISA investments.

AUTIF therefore recommends (a) that authorised Futures and Options Funds be eligible investments for PEPs and for the stocks and shares component of ISAs and (b) that all UCITS funds be eligible.

OFFSHORE FUNDS

1. Review the Offshore Funds Legislation with a view to repeal or substantial amendment

In 1984, legislation was introduced which aimed to prevent tax avoidance by UK residents investing in collective investment schemes established offshore. The measures were felt necessary because, at the time, the tax environment made it highly desirable to turn income into capital gains where possible, as the two were taxed very differently.

The offshore funds legislation more or less ensured that this could not be done by imposing a requirement that a fund should distribute almost all its income each year, thus bringing the investor's share of any income into charge annually rather than allowing it to be rolled up and realised when spare capital gains allowances were available. Failure to comply with this 'distributor status' meant that a fund was treated as having distributed income in any event, and upon disposal any gain was taxed under a more punitive area of income tax law.

The tax and regulatory environment has moved on considerably since those days, and it is no longer the case that offshore funds are only located in tax havens with the objective of saving tax for their investors. A great deal of cross-border selling now goes on, capital gains tax and income tax are far more closely aligned so that there are fewer benefits to obtaining Capital Gains Tax treatment, and the EU Treaty requires that Member States should not implement or persevere with tax rules which distort competition. The UK offshore funds legislation has been identified by a recent report commissioned by FEFSI[2] as perhaps the most notorious example of harmful tax practices and is likely to be subjected to scrutiny by the European Commission.

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[2] FEFSI, the Fédération Européenne des Fonds et Sociétés d'Investissement, represents the interests of the European investment funds industry. Their report, "Discriminatory tax barriers in the single European investment funds market: a discussion paper", is available on request.

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Fund structures have also developed, and different tastes have emerged for European investors as compared with UK investors. Continental investors tend to favour 'gross roll up' share classes, whereby any income is added to the value of the fund and the whole amount is treated as capital upon disposal. Fund managers wishing to sell in Europe must offer such a facility or marketing their product is all but impossible. Yet these types of share class are prohibited from obtaining distributor status, and the existence of such a class will automatically fail an entire fund, triggering the income tax treatment for any UK investor, even one to whom that share class is unavailable.

Similarly, a fund organised as an umbrella structure, such as a Luxembourg sicav, must be a distributor fund in its entirety if the more punitive type of treatment is to be avoided for its UK investors. If one or more of its subfunds is not pursuing the distribution policy, the whole fund fails the test. The test is outmoded in respect of the way funds are organised and marketed, and means that fund management groups must run different types of fund in order to sell across the whole of Europe, which is expensive and inefficient.

AUTIF supports the approach made earlier this year by the Fund Managers' Association which is seeking abolition or substantial reform of the offshore funds legislation.

INHERITANCE TAX

1. Exempt holdings of UK-registered investments held by non-domiciled individuals

Current Inheritance Tax laws dictate that all UK-situated property of an individual who is not domiciled here is subject to tax upon death. The effect of this is to deter foreign investors from taking out investments registered in the UK, and thus potentially keeps a great deal of money out of the UK in favour of jurisdictions which do not impose tax in this way.

There is a clear opportunity for inward investment into the UK to be encouraged by abolition of this rule as far as it applies to holdings of stocks and shares held either directly or within a collective investment vehicle. The tax forfeited would, we believe, be minimal, as currently the rule is preventing UK shareholdings by non-domiciliaries and reaping only small amounts of revenue.

AUTIF therefore recommends that holdings of UK-registered investments held by non-domiciled individuals be exempt from inheritance tax.

SDRT

1. Exempt Funds of Funds structures from SDRT

Stamp Duty Reserve Tax is payable on dealings in unit trusts at the rate of 0.5% on the value of units redeemed. Where the units held are in a Fund of Funds, a vehicle which

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invests in a number of other unit trusts, SDRT is levied both at the level of the units held by the investor and at the level of the units their fund invests in. In addition, stamp duty is payable on UK equities held by the underlying funds. As a consequence, Funds of Funds suffer tax or duty at three levels and are an expensive vehicle to invest in relative to simple unit trusts, we believe unfairly. It also makes it difficult, if not impossible, for Funds of Funds to achieve CAT standards.

S99(5A)(b) of the Finance Act 1986 states that investments in unit trusts or oeics are not chargeable securities provided that the scheme property can only be invested in exempt investments. Subsection 5B(b) goes on to specify that an underlying investment in a unit trust or oeic will only be classified as exempt if the income arising from the investments is taxable under Schedule D Case III, and the terms of the trust specify that only exempt investments are permitted.

The effect on Fund of Funds structures is that the top fund is only exempt from SDRT where each and every fund it is invested in qualifies as an exempt fund. This can only be achieved where a Fund of Funds is wholly invested in 100% UK bond or cash funds, or in overseas securities funds. Where this is not the case, stamp duty or SDRT will normally be suffered at three levels; once on the purchase of the underlying shares and securities (unless exempt), once on surrenders of units at the underlying fund level and finally on surrenders of units in the top fund.

It is our belief and that of our members that this scenario is too restrictive. We are not aware of any Fund of Funds that are non-chargeable, and believe it is unlikely that any exist.

> Example
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> Taking a very simplified case, of a Fund of Funds that is invested in two underlying funds of equal size, one of which invests in an even mix of UK and European equities while the other is limited to UK bonds. The limited scope of the exemption means that although the UK bond fund complies with the rules, SDRT is chargeable in full on the top fund because the equity fund does not comply.
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> Thus an investment in the underlying funds via a Fund of Funds generates a full, unmitigated charge to SDRT whereas a direct investment into the two underlying funds would only have had SDRT charged on one quarter of the portfolio, the proportion which is invested in UK equities.

This clearly has the effect of making investments via Fund of Funds more expensive than making investments directly into the underlying funds. We believe this is detrimental to a product which otherwise offers substantial advantages for certain types of investor. In particular, for investors lacking the skill or confidence to make decisions on their investment portfolio, Funds of Funds reduce risk while allowing investors to participate in an actively managed fund. They simplify the investor's tax position by combining exposure in several funds into a single holding, and they permit greater opportunities to exploit economies of scale.

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However, the treatment of Fund of Funds under s99 means that their investment value is diminished by an overweight apportionment of SDRT. We do not believe this was an intended consequence of the drafting of the legislation. It currently, therefore, generates an anomaly which ought to be removed.

As in other areas of taxation, we believe that no individual should be disadvantaged by choosing to invest in a fund compared with investing directly in its underlying portfolio. A Fund of Funds is simply a convenient device to permit a single investment to be exposed to different investment strategy and performance, and should not be treated as the first of three separate layers of investments as this legislation causes it to be.

AUTIF recommends that the simplest way of achieving fairness would be to exempt the top fund from SDRT altogether, leaving the underlying funds to be taxed according to their relative proportions of exempt and non-exempt investments. This solution would properly reflect the situation as if the investor were a direct participant in the funds in which his money is actually invested. Also, it is simple: it could be achieved with minimal need for additional legislation; administration for providers would be straightforward; and the Treasury impact would be small.

2. Exempt re-organisations of fund ranges from SDRT

It is common within the financial services industry for different groups to merge or engage in takeovers. In the past few years we have seen several very big such transactions – Prudential and M&G, Lloyds TSB and Scottish Widows, Halifax and Bank of Scotland, and INVESCO and Perpetual, to name but a few. When these complex groups combine they frequently find themselves with a large number of investment funds managed under different brand names but offering very similar investment strategies. Running a fund is expensive, and frequently cost savings are identified in streamlining a fund range so that all similar funds in one sector are merged and re-organised into just one product rather than several. This has advantages to the investor of greater economies of scale and a more focused approach by the fund manager.

Increasingly we have been hearing from our Members that the streamlining they would like to be able to do is thwarted by the rule that mergers of unit trusts and oeics are potentially subject to Stamp Duty or SDRT at fund level, or unit level, or both. The charges they would incur are of such a size as to overshadow the cost savings which might be enjoyed, and consequently reorganisations must be structured very carefully to mitigate the charges. The structuring adds complication, and extremely costly professional fees are incurred which again serve to reduce the economic benefits of re-organising.

Furthermore, with the implementation of the new oeic regulations (which will enable oeic money market funds, futures and options funds, and funds of funds to be established), plus the imminent adoption of the revised UCITS Directive (which will enable such funds to qualify as UCITS), there will be an increasing commercial need to re-organise.

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There is a clear absence of commerciality in the existing law when it puts obstacles in the way of companies wishing to rationalise and better equip themselves to cope with increasing competition within the market. It also ignores the fact that re-organisations of this sort do not involve investors realising their investment with our Members, and therefore should not be treated as though they do.

The position could be remedied by granting an exemption, without expiry date, from SDRT and Stamp Duty for groups wishing to re-organise their unit trust and oeic ranges. We believe it could be achieved in a similar way to the existing capital gains tax relief contained within s136 Taxation of Chargeable Gains Act 1992, by means of advance clearance granted by the Inland Revenue upon an application demonstrating that the reorganisation does not have as one of its objectives the avoidance of tax or Stamp Duty.

Once again, we believe that such a change would cost the Treasury little because, as stated above, the level of the tax currently applicable is capable of being mitigated, but only through undertaking complex and costly structuring of the transaction. We contend, therefore, that relatively little SDRT is currently being earned from this rule. However, the Government might expect the amalgamated fund range to yield Stamp Duty when the investment strategies are aligned and securities bought and sold accordingly.

AUTIF therefore recommends that an exemption from SDRT and Stamp Duty be introduced on the re-organisation of unit trusts and oeics.

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