Clients&FriendsMemo

Edinburgh Reforms

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The UK Government has announced wide ranging reforms to the UK financial services industry, including key tax reforms

On 9 December 2022, the UK Chancellor of the Exchequer, Jeremy Hunt, announced the "Edinburgh Reforms" of UK financial services. These reforms propose over 30 regulatory reforms that are described as intending to "unlock investment and turbocharge growth in towns and cities across the UK".

Notwithstanding that the majority of the reforms are focused on regulatory aspects, there are several key announcements relating to UK taxation. Specifically, the UK Government has announced a public consultation on the VAT treatment of fund management as well as announcing that the UK "Investment Transactions List" will be expanded to include cryptoassets. In addition, the UK Chancellor announced that changes will be made to the UK real estate investment trust ("**REIT**") regime.

We have covered each of these announcements in detail below.

Proposed changes to the REIT taxation regime

As part of a speech announcing the Edinburgh Reforms, the UK Chancellor announced that changes will be made to the UK REIT regime. These changes are in addition to those made to the REIT regime by the Finance Act 2022 and are intended to further increase the attractiveness of the regime. The changes will remove the requirement for a REIT to own at least three properties in its property rental business if the REIT holds a single commercial property worth at least £20 million. The changes will also make, as yet unspecified, amendments to the rule that provides that a property is deemed to be sold in the course of a trade if it is sold within three years of development by the REIT and the cost of development exceeded 30 per cent. of the fair value of the property when acquired or on entry into the REIT regime. It seems likely that both changes will allow additional flexibility in the UK REIT regime, and thereby broaden the scope of the UK REIT sector. These changes to the REIT regime will apply from April 2023.

Consultation on VAT treatment of Fund Management

As part of the Edinburgh Reforms announced by the UK Government, the UK Government has launched a public consultation on the VAT treatment of fund management. The consultation, published on 9 December 2022, is part of an ongoing review of the UK's funds regime covering tax and relevant areas of regulation. The consultation proposes an amendment to UK legislation governing the VAT exemption of certain fund management services to improve policy certainty and remove the reliance on retained European Union law which has survived despite the departure of the UK from the European Union.

Reasoning behind the Consultation

The rationale for the consultation is that for many years the VAT treatment of fund management in the UK has mainly been derived from the EU VAT Directive (2006/112/EC, in this article referred to as the "**Directive**"). The Directive provides expressly, in Article 135(1)(g), for a VAT exemption of the management of funds known as Special Investment Funds, or "SIFs". EU Member States have, broadly, delineated the boundaries of an SIF within the requirements of EU law (as interpreted by the Court of Justice of the European Union). Any management of funds that do not qualify as SIFs is subject to VAT at the standard rate, and is not an exempted supply for VAT purposes. Before Brexit, this legislation had direct effect in the UK, and was therefore retained in UK law as part of the UK's Brexit settlement for retained European Union law.

The current UK VAT fund management regime is provided for by UK statute legislation, retained EU law and caselaw. Items 9 and 10 of Group 5 of Schedule 9 of the UK Value Added Tax Act 1994 ("**Items 9 and 10 of Group 5**") contain a list of specific types of funds, the management of which is exempted from VAT. This list was originally intended to ensure equivalence of VAT treatment of fund management between the UK and the EU by specifying which funds qualify as a SIF in the UK.

The list in the UK legislation has been amended from time to time, mainly to keep track of case law which has determined that a wider range of funds (such as, for example, certain investment trusts) should also be treated as SIFs, and in response to policy developments regarding which funds should be granted a VAT exemption for the provision of their management supplies. That legislative evolution has also attempted to track the increasing sophistication of the fund management industry and proliferation of fund types.

The absence of a clear definition of a SIF (as opposed to the lists in Items 9 and 10 of Group 5) in existing UK legislation has not assisted legislative certainty or practical consistency. The approach of maintaining an evolutionary Items 9 and 10 of Group 5 list is therefore to be replaced with a new statutory definition of an SIF. The new definition also provides an opportunity for the UK government to remove from UK tax legislation the residual European Union law on SIFs.

The proposed reforms

The proposed reforms are not intended to result in a significant policy change in VAT treatment for the fund management industry. The aim is consolidation of the current VAT treatment of fund management, to prevent fund managers in the UK needing to rely on a patchwork of the existing UK exemptions in Items 9 and 10 of Group 5 and the SIF criteria derived from European Union law. The consultation proposes:

(i) retaining the list of exempt fund types currently comprising Items 9 and 10 of Group 5. The Government does not intend to expand that list in the future, so the retention is primarily focused on supporting UK fund management industry that currently utilises these provisions, and which would not otherwise meet the a new legislative SIF definition, and to ensure continuity through an effective codification of Items 9 and 10 of Group 5.

(ii) make legislative changes to bring relevant case law and guidance into UK law. This is an attempt by the Government to establish a defined criteria to determine which funds are entitled to the SIF exemption, alongside the existing list of funds in Items 9 and 10 of Group 5.

If this approach was adopted, the Government propose the following requirements for a fund to be considered a SIF:

(a) the fund must be a collective investment;

(b) the fund must operate on the principle of risk-spreading;

(c) the return on the investment must depend on the performance of the investments, with the holders bearing the risk connected with the fund; and

(d) the fund must be subject to the same conditions of competition and appeal to the same circle of investors as a UCITS (Undertakings for Collective Investment in Transferable Securities), being a fund intended for retail investors.

The proposed legislation does not include a requirement for the fund to be subject to "State supervision", as is required in the European Union's legislative guidelines, in order to enhance clarity post-Brexit. This is a departure from EU law and the judgment of the Court of Justice of the European Union in the case of *Fiscale Eeinheid X NV* (Case C-595/13). The government proposes that the legislation should contain a clear definition of "collective investment", with the intention being for the definition to mirror the familiar provisions within the Financial Services and Markets Act 2000. This might need some degree of guidance and regulatory oversight, given how collective undertakings might be marketed to UK retail investors.

The consultation document seeks views on a proposed amendment to UK legislation, and is open until 3 February 2023. The Government has stated it will publish a formal response, and associated next steps, which will presumably include draft legislation, once consultation responses have been collated.

How broad-reaching is the Consultation?
While the consultation's aims are clear, they are also narrow. The Government states that "other options for policy reform in relation to fund management services do not fall within the scope of this consultation". This leaves open the question of how the VAT treatment of management fees to non-retail funds, such as the Government's onshore professional investor fund, might be managed.

Additional questions regarding the VAT treatment of services of management to non-collective investment vehicles, such as securitisation companies, to place UK-resident vehicles on the same footing as European competitors, is also not mentioned in the consultation.

The consultation also does not address issues regarding VAT input tax recoverability for UK-based fund managers where a non-UK fund vehicle is receiving supplies and is not intended for retail investors. It is hoped that this will be clarified in the Government's responses to the consultation to prevent disadvantages to domestically based UK investment managers.

UK Government includes cryptoassets within the scope of the UK's IME
The UK Government has also confirmed in the Edinburgh Reforms that the "Investment Transactions List" ("**ITL**") will be expanded to include cryptoassets. This follows the UK Government's public consultation on this topic, which was held earlier in 2022.[1] The consultation specifically sought views on the types of cryptoassets that should be included within the ITL, which is of particular important to the UK's investment manager exemption ("**IME**"), and whether there is a case for extending this change to tax regimes for funds which also use the ITL.

Defining Cryptoassets
At the consultation stage, the UK Government proposed using the Crypto-Asset Reporting Framework ("CARF") definition. The UK Government has concluded that the CARF definition should form the basis of the definition for the ITL. Such definition provides that:

> *"the term "cryptoasset" refers to a digital representation of value that relies on a cryptographically secured distributed ledger or a similar technology to validate and secure transactions."*

[1] This was considered in Cadwalader's "Brass Tax" monthly taxation newsletter in June 2022, click here.

This definition was regarded as the most suitable definition for UK tax purposes on the basis that it was suitably wide-ranging to encompass the products and investments which are of interest to the investment sector, will likely be used by other tax authorities and somewhat future-proofs the definition by referring to "similar technology".

However, during the consultation process, the UK Government considered responses which identified limitations in this approach, including that alternative definitions are already used in existing UK or European Union regulatory legislation or are being consulted on for the purposes of UK regulatory legislation. It has been noted that the HMRC Cryptoasset manual currently adopts a definition of cryptoassets which is similar to the European Union's Markets in Crypto Assets ("**MiCA**") definition. As such, it is expected that the definition used in the HMRC Cryptoasset manuals should be aligned to the ITL definition.

In addition, the UK Government also considered the nature of any exclusions from the proposed definition, given the current limitations on the scope of the ITL such as excluding assets which include transactions in land, the transfer of assets not already included in the ITL and closed-loop cryptoassets. The UK Government has stated that, among other things, cryptoassets which provide rights in relation to other property will be included so long as the transaction does not result in the delivery of the property as will transactions in cryptoassets that represent rights in relation to assets (provided that transactions in those assets would currently fall within the ITL). This approach reflects the current scope of assets with ITL. However, the UK Government has confirmed that cryptoassets created or issued by the investment manager, non-resident fund or parties connected to them will be excluded from the ITL.

Collective Investment Arrangements

In addition to applying to the UK IME, the ITL also applies to certain UK tax regimes for funds. Specifically, the ITL is used to identify transaction which would generally be considered to form part of an investment business and would not generally be viewed as trading activities. As such, UK investment managers of both UK and overseas funds obtain the same level of certainty about the types of transaction which will not be taxed as a trading activity in the UK.

Whilst the consultation sought responses to whether the changes to the ITL should be extended to the fund tax regimes which also use the ITL, HMRC commented that, based on the responses to the consultation questions, there appears to be little demand to deal in cryptoassets from the funds which rely upon the ITL. Accordingly, the UK Government does not consider that there is sufficient demand to warrant extending this change to the fund tax regimes.

Timetable for introduction

HMRC has noted that the regulations implementing the changes to the ITL are intended to be introduced by the end of the 2022 calendar year to have effect in relation to transactions entered

into during the 2022-23 tax year for non-corporate entities and accounting period current on 31 December 2022 for corporates.

The expansion of the ITL, in so far as it is used for the purposes of the UK IME, will have meaningful benefits to UK investment managers. The changes also demonstrate the commitment of the UK Government to ensuring that the UK is a leader in both investment management and cryptoasset businesses.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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