HM Revenue & Customs

Co-ownership authorised contractual schemes (CoACS) – reducing tax complexity for investors - technical note

1. Introduction

This technical note describes a number of recent tax changes in connection with co-ownership authorised contractual schemes (CoACS). Once HMRC manuals have been updated to reflect these changes, this note will be withdrawn.

2. Background: context for changes

Co-ownership authorised contractual schemes (CoACS) were introduced in 2013. They must be authorised by the Financial Conduct Authority (FCA). The operator and depositary of a CoACS must also be FCA authorised persons.

CoACS are transparent for the purposes of tax on income. That means income accruing to the CoACS is automatically the income of investors in the CoACS in proportion to their investment. Investors in CoACS benefit from a simplification for the purposes of chargeable gains: the investors' units in the CoACS are treated as the 'asset' for the purposes of taxation, and the underlying assets held in the CoACS are disregarded.

Further tax changes have been introduced to clarify the tax context for investors in CoACS. Those changes are in the following areas:

- Capital allowances;
- Information requirements;
- Investments in offshore funds; and
- Chargeable gains.

These changes are described in detail in this technical note.

3. Capital Allowances

3.1 Introduction

Because CoACS are transparent for the purposes of capital allowances, the investor – not the scheme – may be entitled to claim capital allowances subject to the normal rules. However, the operator of the CoACS holds the information which investors require to calculate their entitlement to capital allowances.

To avoid the need for exchanges of information between the operator and investors, the government introduced a simplified scheme of calculating capital allowances whereby the operator of a CoACS may calculate the allowances and allocate them to investors. That

scheme is contained in sections 262AA-AF of the Capital Allowances Act 2001 ("CAA01"), which were inserted by section 40 of the Finance (No 2) Act 2017.

The new scheme is elective because some CoACS have only or mainly investors who are exempt investors, and who therefore are not entitled to claim capital allowances. To impose the new scheme on those CoACS would be an unnecessary administrative burden.

3.2 Qualifying activity

To claim capital allowances, a taxpayer must be carrying on a qualifying activity as defined in s15 CAA01. HMRC guidance is contained in the Capital Allowances Manual at CA20010.

An operator of a CoACS can elect into the simplified scheme if the investors carry on a qualifying activity collectively. The simplified scheme treats an investor as carrying on the collective qualifying activity on an individual basis so that the investor is potentially eligible to claim allowances. Allowances can only be claimed to the extent that the profits or gains arising to the investor are chargeable to tax.

3.3 The election into the simplified scheme

The operator of a CoACS has the option to elect to calculate capital allowances at CoACS level and to then allocate these allowances to investors. The operator is required to calculate allowances as if all investors were taxable. (As above, an investor can only claim allowances to the extent that its profits or gains from the qualifying activity are or would be chargeable to tax.)

If an operator chooses not to make an election then investors may still be entitled to claim capital allowances, but the simplified scheme will not be available.

Only the operator can elect into the simplified scheme. It is expected that the contractual relationship between the operator and investors, as well as regulatory obligations, will mean the operator will act in the interests of investors generally when it decides whether to make the election.

The election must specify an accounting period of the scheme as the first accounting period in which the election has effect. This accounting period must not be longer than 12 months and an election can be made for any accounting period beginning on or after 1 April 2017.

Once an election has been made it has effect for that first accounting period and all subsequent accounting periods of the scheme. This means that the operator does not have to elect for every accounting period and once an election has been made it is irrevocable.

In the case of a CoACS which is structured as an "umbrella" fund with a number of sub-funds, each sub-fund is treated separately for the purposes of capital allowances and an election into the simplified scheme should be made for each applicable sub-fund. This follows on from the regulatory regime which treats investors in a sub-fund as tenants in common in that sub-fund.

The election is made by the operator by notice to an officer of Revenue and Customs, in the same way as other elections for capital allowances purposes.

3.4 Calculation once an election has been made

Where the operator of a CoACS has elected into the simplified scheme, the operator should calculate the allowances that would be available for the relevant period based on a set of assumptions outlined below:

a) The scheme is a person;

b) The relevant period is a chargeable period for the purposes of the Act;

c) Any qualifying activity carried on by the investors in the scheme together is carried on by the scheme;

d) Property which was subject to the scheme at the beginning of the first accounting period for which the election has effect –

   (i) Ceased to be owned by the investors at that time, and

   (ii) Was acquired by the scheme at that time;

e) The disposal value to be brought into account in relation to the cessation of ownership and the acquisition referred to in (d) is the tax-written down value;

f) Any property which became subject to the scheme at a time during an accounting period for which the election has effect was acquired by the scheme at that time;

g) Property which ceased to be subject to the scheme at any such time ceased to be owned by the scheme at that time;

h) The disposal value to be brought into account in relation to the cessation of ownership referred to in (g) is the tax written down value;

i) The scheme is not entitled to a first year allowance or an annual investment allowance in respect of any expenditure.

The operator of the CoACS scheme must allocate to each investor in the scheme a proportion of the allowances calculated. The proportion has to be made on a **just and reasonable** basis. In determining what is just and reasonable the operator has to take into account the relative size of each investor's holding of units in the scheme. The operator must not take into account the investor's liability to any tax.

The investors are only allowed to claim allowances that have been allocated to them by the operator. They cannot claim allowances for amounts greater than the amount allocated.

The operator must make a calculation for each individual qualifying activity and allocate separately for each separate activity.

3.5 Tax written-down value, first-year allowance and annual investment allowance

The purpose of the elective scheme is to deliver simplified arrangements for investors in CoACS.

In relation to any cessation of ownership or acquisition, tax written down value (TWDV) means the amount that would give rise to neither a balancing allowance nor a balancing charge on the assumption that the relevant expenditure were in a single pool and all profits and gains of the activity were liable to tax.

Claims for the first-year allowance (FYA) and annual investment allowance (AIA) are not available within the elective scheme. As well as simplifying the rules, this avoids the need for

exchanges of information between investors and the operator of a CoACS to establish the investor's capital allowances position generally.

3.6 Effect of election for purchasers

If a person purchases property from a CoACS and the operator has elected into the simplified scheme, the purchaser must obtain a written statement from the operator of the assumed TWDV disposal value of the plant and machinery fixtures within 2 years of the purchase of the property. The purchaser's qualifying expenditure is limited to this TWDV disposal value.

If the purchaser fails to obtain the written statement within the 2 year time limit, the purchaser's qualifying expenditure is treated as nil.

4. Information requirements

4.1 Introduction

CoACS are transparent for income purposes. That means that income accruing within the CoACS is the income of the investors when the income arises. Investors therefore must rely on information from the CoACS specifying what income has arisen to them and when. They also need other information to complete their tax returns – for example, the amount of any capital allowance allocated to them. This information may be provided by the operator of a CoACS under a contractual obligation.

At present, HMRC receives no information from the operator of a CoACS – because the CoACS is transparent, it is not required to submit a tax return. As a result, HMRC is unaware who are the investors in a CoACS, how much income has accrued to them during a tax year or accounting period, etc.

The government has decided to introduce specific legal requirements on the operator to provide certain information to investors and to HMRC. Section 41 of Finance Act (No 2) 2017 enabled the government to make regulations specifying the detailed requirements, which are contained in The Co-ownership Authorised Contractual Schemes (Tax) Regulations 2017 (SI 2017/1209).

4.2 Providing information to investors

The operator of a CoACS must provide investors with sufficient information to fulfil their tax obligations. The requirement is intended to be flexible depending on the information needs of the industry. HMRC expects that the CoACS will notify investors of:

- The amount of income which has arisen to them during a period of account;
- The amount of any deductible expenses allocated to them;
- The amount of any capital allowance allocated to them; and
- Such amounts and other adjustments which would enable an investor to calculate the chargeable gain on disposal of units in the CoACS.

Other information may be required depending on the circumstances.

In relation to income, UK resident investors in a CoACS will require details of the type of income received, such as any income from property, dividend income, interest receivable and so on. This will include details of any income that has had tax withheld.

Investors who are exempt from UK taxation may require less information for UK tax purposes (although they may still need to complete a tax return). The information required by overseas investors will depend on the tax treatment of income and gains in the jurisdiction in which they are resident.

The information required is readily available to operators of CoACS and the requirement should not be burdensome.

4.3 When information must be provided to investors

The regulations require the operator to provide this information by the "information reporting date" – the date six months after the end of the period of account of the CoACS.

It has been suggested to HMRC that certain information, such as capital allowances, may not be available by that date. HMRC expects that operators of CoACS will take reasonable measures to meet the deadline, but welcomes feedback from the industry on how the timings operate in practice.

4.4 Providing information to other CoACS

As with providing information to investors, the operator of a CoACS (C1) must also provide sufficient information to the operator of another CoACS (C2) if it has invested in C1. This enables C2 to make a proper report to its own investors.

4.5 Providing information to HMRC

The new regulations also require the operator of a CoACS to provide specified information to HMRC for each period of account of the COACS:

- The names and addresses of all investors in the scheme.
- The number and classes of units in the scheme at the end of the period.
- The amount of income per unit for each class.

4.6 When information must be provided to HMRC

The regulations require the operator to provide information to HMRC by the information reporting date – the date six months after the end of the period of account of the CoACS.

4.7 Further Information to be provided to HMRC.

If HMRC requires more information from the operator of a CoACS, the regulations enable HMRC to require the operator of a CoACS to disclose any other information which has been provided to the investors.

HMRC can ask for information relating to periods of account which have ended within 5 years of the notice for information being given. The operator of a CoACS would have a minimum of 42 days to respond to HMRC before consideration of any penalties.

If HMRC needs to obtain further information from the operator of a CoACS, it will contact the operator in the first instance to explain what information is required and agree a suitable timescale for its production. HMRC will use the formal power to require the operator of a CoACS to provide information if the initial approach is unsuccessful.

4.8 Penalties for failing to provide information to investors or to HMRC

The regulations provide for two separate penalties in the event that the operator of a CoACS fails to provide the required information to investors or to HMRC. Penalties may arise when:

1. The operator of a CoACS fails to provide information by the information reporting date.
2. Where HMRC has given notice that further information is required, the operator of a CoACS fails to provide that information to HMRC.

These penalties are explained in more detail in the following sections.

4.9 Penalty for failing to provide information

This penalty concerns information the operator of a CoACS must provide to investors and to HMRC by the information reporting date.

If the operator of a CoACS fails to provide information to investors, to another CoACS or to HMRC, the operator is liable to a penalty of £60. The charge of £60 is for each occurrence, up to a maximum of £600 per any period of account.

4.10 Penalty for failing to provide further information following a HMRC notice

This penalty concerns information the operator of a CoACS must provide in response to a formal HMRC notice to produce further information.

If the operator of a CoACS fails to provide information requested under a notice by HMRC the operator is liable to a penalty not exceeding £3000.

This amount is determined in accordance with section 100 of the Taxes Management Act (1970) and is subject to the usual review and appeal processes for penalties made under that section. HMRC guidance is contained in the Enquiry Manual from EM5200 onwards.

5. Investments in offshore funds

5.1 Introduction

UK law contains a number of rules which ensure that income accruing within transparent offshore funds is allocated as the income of any UK investors. At present, when a CoACS has invested in an offshore fund there are no specific rules which ensure that accrued income is allocated to investors, meaning that the rules for CoACS are out of step with the rules for other UK authorised funds.

The government has decided to introduce specific legal requirements on the operator of a CoACS to allocate certain amounts to investors as their income. Section 42 of Finance Act (No 2) 2017 enabled the government to make regulations specifying the detailed requirements, which are contained in The Co-ownership Authorised Contractual Schemes (Tax) Regulations 2017 (SI 2017/1209).

The rules differ depending on whether the offshore fund in which the CoACS has invested is a reporting fund or a non-reporting fund. A reporting offshore fund is one where the fund has entered a special regime administered by HMRC in which the fund must submit to investors an annual report of income accruing to them and submit a copy of all such reports to HMRC. Investors in a reporting fund are taxable on any income distributions received and on their share of any excess income for a period of account. A non-reporting fund is any offshore fund that is not a reporting fund.

5.2 Requirements on operators of CoACS

The new regulations require the operator of a CoACS to allocate certain amounts as the income of investors in the CoACS. These rules concern excess income arising in offshore funds which should be allocated to investors in the CoACS. Other income will already flow through to investors via the CoACS.

The operator of the CoACS must notify investors of the additional income by the information reporting date (see section 4.3 above).

5.3 Investments in reporting offshore funds

Where a CoACS has invested in a reporting offshore fund, the operator of the CoACS must allocate certain sums as investors' income as follows.

- Where the offshore reporting fund has made a report of excess income accruing to the CoACS, the operator must allocate that income to CoACS investors in proportion to their investments in the CoACS.
- Where the offshore reporting fund has not made a report of income accruing to the CoACS, the operator must estimate the amount of income to be allocated to CoACS investors in proportion to their investments. If the CoACS subsequently receives a report from the offshore fund, the operator should correct the estimated income in the period in which the report is received.

5.4 Investments in non-reporting offshore funds

Where a CoACS has invested in a non-reporting offshore fund, the operator of the CoACS must allocate certain sums as investors' income as follows.

Case 1: Where the operator of the CoACS has access to the accounts of the non-reporting offshore fund

This rule applies where the operator of a CoACS:

(a) Has access to the accounts of the non-reporting fund;

(b) Has sufficient information to calculate reportable income for the fund; and

(c) Can reasonably expect to have continuing access to that information throughout the period in which it will hold the investment in the fund.

In those circumstances, the operator should allocate an appropriate amount of income to investors in proportion to their investments.

Case 2: Where the operator of the CoACS does not have access to the accounts of the non-reporting offshore fund

In all other cases the operator of a CoACS should establish the movement in the fair value of the interest in the non-reporting fund and allocate appropriate amounts to investors as their income. The amount of income allocated to investors should not be below zero.

“Fair value” means the value of the interest in the non-reporting fund if it was exchanged at arms’ length.

6. Chargeable gains

6.1 Introduction

Investors in CoACS benefit from a simplification for the purposes of chargeable gains: the investors’ units in the CoACS are treated as assets for capital gains purposes, and the underlying assets held in the CoACS are disregarded. A holding of units in a CoACS is treated as a single asset for chargeable gains purposes.

That approach works well but there are perceived weaknesses in the current rules, such as how loan relationship credits and debits arising in CoACS should be treated in the investor’s chargeable gains calculation. Also, the chargeable gains rules for transparent offshore funds are significantly different to those for CoACS.

6.2 Timing of changes & transition

The government has therefore legislated to clarify and improve the relevant rules with effect from 1 January 2018. The Collective Investment Schemes and Offshore Funds (Amendment of the Taxation of Chargeable Gains Act 1992) Regulations 2017 (SI 2017/1204) replace the existing section 103D of the Taxation of Chargeable Gains Act 1992 with new sections 103D and 103DA, as well as making some other minor and consequential changes.

Where an investor disposes of units in a CoACS or an offshore transparent fund on or after 1 January 2018, the chargeable gains computation should take account of:

- Expenditure and other relevant adjustments which arose under the rules in force up to 31 December 2017; and
- Expenditure and other relevant adjustments which arose under the new rules in force from 1 January 2018.

6.3 Treatment of transparent offshore funds

Currently offshore funds are treated for chargeable gains purposes as if they were companies and their units were company shares held by the investors. From 1 January 2018 they will be treated in the same way as CoACS, as described above.

6.4 Treatment of loan relationship credits and debits

When loan relationship and derivative contract debits and credits arise to a CoACS, there has been some uncertainty as to how these should be treated within the chargeable gains calculation.

The revised rules provide for appropriate amendments to be made to the base cost within the chargeable gains calculation:

- Credits are treated as expenditure which increases the base cost; and

- Debits are treated as a reduction in expenditure which in turn reduces the base cost (though not below zero – any excess expenditure will be added to proceeds).

6.5 Part-disposals

If amounts which are not income are paid out of a CoACS or offshore transparent fund the normal chargeable gains rules will treat this as a part-disposal of the holding of units: there may be a liability to tax on any gain accruing at that stage.

It is unlikely that such a part-disposal would arise in relation to a CoACS – amounts which are not income are unlikely to be paid out when there is no disposal of units – although it may occur in relation to an offshore transparent fund.

Amounts paid out of a CoACS which do not constitute a part-disposal of the holding of units should be treated as a reduction in expenditure, which will have the same effect as a loan relationship debit as described above.

6.6 Treatment of capital expenditure

There is a new rule which prevents expenditure which qualifies for capital allowances from being taken into account as expenditure in the event of calculating an allowable loss for chargeable gains purposes. Although this rule already exists within the general rules for chargeable gains, this new rule clarifies the treatment in circumstances where the expenditure is in relation to the underlying asset but the investor's asset for chargeable gains purposes is their holding of unit in the CoACS.

6.7 Unit treated as a security

The new rules clarify the treatment of units in a CoACS as a security for the purposes of the chargeable gains pooling rules. As mentioned above, this means that a holding of multiple units of the same type in a CoACS will normally be treated as a single asset or "pool".

6.8 Insurance companies

There are two new rules which relate to insurance companies.

(a) If units in a CoACS are disposed of by an insurance company to a connected operator of the CoACS, there will be no restriction on the loss relief available to the insurance company. This brings the treatment of units in CoACS into line with other UK authorised funds.

(b) If an insurance company transfers assets to a collective investment scheme in return for units in the scheme (it 'seeds' the scheme) those units are treated as a separate holding to other units the insurance company may hold in the same scheme. This avoids potential distortions in the chargeable gains calculation where seeded and non-seeded units are combined. This new rule applies in relation to all collective investment schemes as defined by the Financial Conduct Authority (FCA).