UNIT TRUSTS, OEICS AND ICVCS

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Unit Trusts, OEICs and ICVCs are investment structures designed to make it possible for a private investor, with a small sum of money, to invest in a **well-diversified** and **professionally managed** portfolio of investments in a **cost effective** and **tax efficient** manner.

These are '**open ended**' investment vehicles; the value of the units or shares fully reflects the value of the underlying assets, and units or shares are issued or redeemed as necessary to reflect demand.

This note looks under the bonnet of these structures to explain exactly how they work.

UNIT TRUSTS

Unit Trusts are in fact true **trusts** in the legal sense, and are controlled by a **board of trustees**. The Trust Deed forms the constitution of the unit trust. It is drawn up by the manager and the trustee and must state the name of the trust, the category of fund and specify the type of investments that may be held within the trust. The shares of a Unit Trust are known as **units**.

An **investment manager** is responsible for the purchase and sale of securities and for the provision of valuations for the trustee. The trustee (usually a bank) is the formal owner of the investments. The investment manager must decide upon investment strategy within the trust deed criteria.

A Unit Trust is **open-ended**, meaning that the number of units is not fixed. New units are created for new investors, whilst the units belonging to investors wishing to sell will be cancelled. This means that the investor **can deal with the unit trust manager directly**, rather than via a stockbroker.

There is a difference between the buying and selling price of units, known as the **bid-offer spread**. The investor buys units at the higher price (offer) and may sell at the lower price (bid). The difference between the two prices will represent the manager's initial charge, any broker commission and certain transactions costs incurred in the creation of new units. In addition, an **annual management charge** will be payable from the assets of the trust. This will cover the expenses incurred in running the fund, which will be higher in the case of equity and specialised funds than for fixed interest or cash funds. The effect of these charges is set out in the Key Features/Simplified Prospectus document.

The **permitted investments** of a Unit Trust are controlled by the Financial Conduct Authority (FCA) and include company shares and fixed interest investments including gilts, corporate bonds and convertibles. Investments in property, money market deposits and warrants are allowed in funds that clearly state that these are their intended investments.

OEICS AND ICVCs

The term ICVC stands for Investment Company of Variable Capital. ICVCs are structured in such a way that they can be offered on a pan-European basis. The structure has also been known as an OEIC, standing for Open Ended Investment Company.

An OEIC/ICVC is structured as a **company**, and is controlled by an **Authorised Corporate Director** (ACD), who fulfils the role of fund manager. The assets of the OEIC/ICVC are owned by the **Depository**, whose role is similar to that of the Unit Trust Trustee.

An OEIC/ICVC is also **open-ended**, meaning that the number of shares is not fixed. New shares are created for new investors, whilst the shares belonging to investors wishing to sell will be cancelled. The investor can **deal with the fund manager directly**.

There is a **single price** at which shares are bought and sold. The fund manager will levy an **additional sales charge** on purchases of shares. This figure will include any broker commission and certain transaction costs incurred in the creation of new units. An **annual management charge** will be levied in the same way as for a Unit Trust.

The **permitted investments** of an OEIC/ICVC are controlled by the Financial Conduct Authority (FCA) and are the same as those for a Unit Trust.

Investment companies usually structure their OEIC/ICVC in such a way as to offer **several share classes to cater for different investor needs**. For example, 'Able Investments' may offer the Able OEIC. The Able OEIC may offer share classes investing in different currencies, or in different investment areas. This structure has advantages for the investment firm, but may also make it easier for an investor to switch between funds.

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TAXATION

Unit Trusts, OEICs and ICVCs are treated in the same way for tax, with the aim being to put the investor in broadly the same income tax position as if they had held the underlying investment directly.

TAX WITHIN THE FUND

- Interest or rental income received by the Unit Trust/OEIC/ICVC is subject to corporation tax at 20%. However, interest payments out to investors can be fully offset again the interest received and so effectively the interest is not taxed until it is in the hands of the investor.
- No tax is paid on the receipt of dividends. Overseas dividends may have suffered some withholding tax at source which may not be reclaimed.
- Annual management expenses may be offset against income (other than dividends), and so can be tax-relieved if there is sufficient taxed income.
- Internal capital gains within an authorised unit trust/OEIC/ICVC are exempt from taxation. Hence the investment portfolio can be managed and traded without tax consequences on the investor – a major advantage over holding equivalent investments directly.

TAX ON THE INVESTOR

- Income may be paid to the investor in the form of interest or dividends, both now paid without the deduction of tax. When the market value of the investment fund is comprised of over 60% in cash or fixed interest, the fund is classed as a non-equity fund and the income payments will be treated as interest for tax purposes. Where this proportion is 60% or less, then income payments will be treated as dividend income for investors.
- The investor is also potentially liable to capital gains tax on gains made when he sells units. The base cost of the units is calculated as an average cost across the 'pool' of units/shares in the fund, except for those bought in the 30 days prior to any sale – in this instance, these are identified separately and are deemed to be the first to be sold.

ACCUMULATION AND INCOME UNITS/SHARES

Income arising within the fund can be treated in one of two ways, reflected in two different types of unit or share that may be issued – accumulation “acc” or income “inc”. Not all funds offer both types of unit/share.

In both cases, the income remains taxable on the investor in the same way, regardless of the type of unit or whether the income is taken or reinvested. An investor can use a ‘share class conversion’ to switch between acc and inc units/shares without it being treated as a disposal for capital gains tax.

ACCUMULATION UNITS OR SHARES

The income arising within the fund is automatically reinvested within the fund itself, and will be reflected in an increase in the fund unit/share price. The tax voucher issued annually will detail the amount of income that the investor needs to declare on their tax return. As this amount is also effectively a new capital investment (as it has been used to reinvest into the fund), then these amounts need to be added to the base cost when performing capital gains calculations, which will reduce the overall gain.

This type of share can be good for investors who do not require income, but can make capital gains records and calculations more complicated and so are generally favoured in tax-wrappers such as ISAs and pensions.

INCOME UNITS OR SHARES

The income arising within the fund is paid out to the investor, who will either withdraw it or may have a standing instruction with the provider to reinvest it, resulting in an increase in number of units/shares held. Again, the tax voucher will show the level of income paid, and if the income is reinvested then it is treated as a new investment for capital gains calculations.

This type of share offers income for investors who require it, and potentially slightly simpler capital gains calculations for those who wish to reinvest the income – however, some providers will make an additional charge for each reinvestment so care should be taken that this is not the case.

EQUALISATION

When income distributions are made, the same income per unit is paid to all unit holders. In the case of those who invested part way through the period over which the income was 'earned', this **first** income distribution received usually includes an 'equalisation' payment.

This represents a partial repayment of the capital invested, because the price paid per unit included accrued income, in order to achieve a broad fairness between unit holders in the apportionment of the income paid.

The equalisation amount is not subject to income tax. However, where the income is withdrawn, it must be deducted from the base cost of the holding when calculating capital gains.

Important information: Our views are based upon our understanding of current legislation in England, unless stated otherwise. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances.

Risk Warning: The past is not necessarily a guide to future performance. The value of your investment and the income from it can fall as well as rise and is not guaranteed. You may not get back the full amount invested. This document is provided for information only and does not constitute advice. You should not act on any of the information without seeking professional advice.